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ARTICLES

Redefining Corporate Law

David Millon*

A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent.[1]

Introduction: A Revolution in Corporate Law?

Shareholders have long enjoyed a privileged position at the center of the corporate law universe. For much of this century, corporate law's principal function has been to render management accountable to them. Toward this end, state corporate statutes (supplemented by federal proxy regulation) provide shareholders with the right to elect directors. In addition, fiduciary principles specify duties of care and loyalty owed by management to the shareholders. In contrast, the various nonshareholder constituencies involved in the corporate enterprise (such as employees, creditors, suppliers, and customers) are of little concern to corporate law. Contracts (supplemented by regulatory statutes), rather than fiduciary duty or other accountability mechanisms, determine management's obligations to these groups. Under this conception of management's role in the corporation, management must accord primacy to shareholder interests in exercising its discretion to manage the corporation's business affairs. Management discharges this responsibility by

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1. Ind. Code Ann. § 23-1-35-1(d) (West Supp. 1990). So far, 27 other states have adopted similar statutes. *See* statutes cited *infra* note 76.

attempting to maximize the company's profits in order to enhance share values.[2]

Recent developments challenge the conventional framework. The catalyst has been the hostile takeover boom of the 1980s. Despite their undoubted value to target company shareholders,[3] highly leveraged "bust-up" acquisitions[4] by means of tender offer are widely perceived to threaten jobs, the security of creditors, established customer and supplier relationships, tax revenues, charitable contributions, and other economic and social benefits provided by resident companies to local communities.[5] Concerns about adverse effects on nonshareholders have resulted in various judicial and legislative efforts to curb hostile takeovers. State courts have been increasingly hospitable toward efforts by target company management to fend off unwelcome takeover bids. This attitude is illustrated most graphically by the Delaware judiciary's recent blessing of Time's rejection of Paramount's attempted acquisition, despite its obvious attractiveness to Time's shareholders.[6] At the same time, state

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2. I use the term "shareholder primacy" to refer to this conception of management's responsibility and also to corporate law's commitment to shareholder welfare as the primary objective of corporate activity. While it is possible to distinguish between them, these two ideas are inextricably linked in traditional doctrine. Management's duty to privilege shareholder interests is based on an underlying assumption about the purpose of corporate activity; and our system of corporate law assigns to corporate management the task of pursuing the underlying shareholder welfare objective. There is nothing inevitable about this linkage: one could imagine a legal system in which some other person or group (*e.g.*, a state agency; the shareholders themselves) was responsible for maximizing shareholder welfare.

3. Premiums paid to shareholders in hostile tender offers have averaged 50% over market price. Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 Colum. L. Rev. 891, 892 (1988).

4. So-called "bust-up takeovers" are motivated by an intention to earn profits by breaking up the acquired corporation and selling off some or all of the constituent parts. This objective, rather than a desire to continue existing operations under new management, has been identified as the dominant reason for hostile takeovers during the 1980s. *See* Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich. L. Rev. 1, 2-7 (1986).

5. *See, e.g.*, Chairman of the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess., Report: Corporate Takeovers: Public Policy Implications for the Economy and Corporate Governance (Comm. Print 1987), *reprinted in* L. Solomon, D. Schwartz & J. Bauman, Corporations: Law and Policy 1149, 1162-63 (2d ed. 1988); Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 14 J. Corp. L. 35, 67 (1988); Proxmire, *What's Right and Wrong About Hostile Takeovers?*, 1988 Wis. L. Rev. 353; *see also* Edgar v. MITE Corp., 457 U.S. 624, 646 (1982) (Powell, J., concurring).

6. *See* Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989), *aff'd*, 571 A.2d 1140 (Del. 1990)

legislatures have adopted a potent array of statutory measures designed to slow the pace of hostile takeover activity.[7]

By empowering target company management to prevent shareholders from enjoying the benefits of a robust takeover market, these developments indicate a willingness to subordinate shareholder financial interests to other values. In this respect, they conflict with corporate law's traditional commitment to shareholder primacy. Even more dramatic, however, is the recent wave of statutes expressly redefining corporate management's duty. Though they differ in detail, in form these new directors' duty statutes[8] authorize management to consider the interests of various nonshareholder constituencies (typically including employees, creditors, suppliers, consumers, and local communities) in making business decisions. If a particular decision would harm the interests of one or more of these groups, management need not adopt it, no matter how beneficial that course of action might be to shareholders. These statutes abrogate the long-standing shareholder primacy requirement, and most are not confined to the hostile takeover setting.

The new directors' duty statutes confront corporate law's most basic premises. If the traditional conception viewed the corporation as an engine for shareholder wealth maximization and shaped legal doctrine accordingly, the new statutes suggest a more complex notion of the corporation's role in society. At the core of this new conception — vague and tentative as yet — is the recognition that a number of nonshareholder constituencies depend upon the corporation for their welfare and are therefore affected directly by the manner in which management conducts the corporation's affairs. Relentless pursuit of

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(refusing to enjoin preliminarily Time's defensive acquisition of Warner despite Paramount's offer of premium substantially over market price). For discussion of this decision's broad implications, see Johnson & Millon, *The Case Beyond* Time, 45 Bus. Law. 2105 (1990) [hereinafter Johnson & Millon, *Case Beyond* Time].

7. *See generally* Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 Mich. L. Rev. 846 (1989) (discussing motivations behind various forms of antitakeover statutes) [hereinafter Johnson & Millon, *Missing the Point*].

8. Because in form they define the manner in which directors should discharge their duties to the corporation, I term these statutes "directors' duty statutes." Others have referred to them as nonshareholder (or nonstockholder) constituency statutes or stakeholder statutes. *See* Hanks, *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Come*, 3 Insights 20 (1989); Karmel, *The Duty of Directors to Non-Shareholder Constituencies in Control Transactions—A Comparison of U.S. and U.K. Law*, 25 Wake Forest L. Rev. 61, 66-68 (1990) (referring to stakeholder statutes); Note, *A Framework for Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. Pa. L. Rev. 1451 (1990); *see also A.B.A. Section of Business Law, Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion*, 45 Bus. Law. 2253 (1990) [hereinafter ABA Report].

profit maximization for their sake can impose substantial costs on nonshareholders. Corporations are more than just investment vehicles for owners of financial capital. The new statutes reflect a desire to redefine management's responsibilities in light of this fact.

Nearly thirty states have adopted various versions of the directors' duty statutes,[9] and more can be expected to do so in the months to come. Although the new statutes' general thrust is clear enough to have attracted some critical commentary,[10] they have not yet been subjected to judicial scrutiny[11] or sustained academic analysis.[12] As a result, the full implications of these terse and, in some ways, distressingly vague enactments are far from clear. This Essay begins, in Part I, with a sketch of the background from which the new statutes emerged. This is intended to furnish the context necessary to appreciate the statutes' apparently sharp break with the past, as well as the circumstances that led to their passage. An understanding of the statutes' background is necessary if we are to make sense of their mandate. Part II offers a description of the statutes' content, drawing attention to what is new as well as to what is not. Part III then considers, in detail, doctrinal implications with respect to shareholder primacy. By analyzing the statutes' abrogation of the shareholders' right to hold management accountable for deviations from profit maximizing strategies, this section deals with what might be termed the negative aspect of the statutory agenda. Part IV then takes up the separate question of the extent to which the directors' duty statutes affirmatively oblige management to protect nonshareholder interests. Initially, two interpretations of non-

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9. *See* statutes cited *infra* note 76.

10. An American Bar Association committee has published its analysis of the directors' duty statutes, undertaken to determine whether the Revised Model Business Corporation Act should be amended. ABA Report, *supra* note 8. The report is critical of the statutes and recommends against amendment, but the committee's conclusion apparently was not unanimous. *Id.* at 2254. For a briefer and sharper critique written by a respected lawyer for an audience of practicing lawyers and business executives, see Hanks, *supra* note 8.

11. Directors' duty statutes have been referred to in two decisions, but in neither did the court explain the relation between statute and outcome, if any. *See* Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis.) (citing Wisconsin statute), *aff'd*, 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989); Baron v. Strawbridge & Clothier, 646 F. Supp. 690 (E.D. Pa. 1986) (citing Pennsylvania statute).

12. Paul Cox considers the Indiana directors' duty statute in the context of an insightful analysis of that state's broad array of antitakeover legislation. *See* Cox, *The Indiana Experiment in Corporate Law: A Critique*, 24 VAL. U.L. REV. 185 (1990). A student author offers useful suggestions about strategies available to management for satisfaction of its responsibilities to nonshareholders under the new statutes, but only briefly discusses the statutes themselves. Note, *supra* note 8.

shareholder rights under the new statutes (the "no new rights" and "minimal protection" interpretations) are suggested. Under either of these, protection of nonshareholders would depend on management's willingness to use its discretionary power for nonshareholders' benefit. However, it turns out that various incentives make it highly unlikely that this will occur. Accordingly, if the statutes are to have any meaningful effect, a stronger interpretation is needed. This is also presented in Part IV, and consideration of some objections then follows.

Corporate law is in a state of conceptual turmoil. Fundamental questions that seemed firmly settled a generation ago — about the appropriate aims of corporate law and about corporate purpose itself — no longer command consensus. This is nowhere more apparent than in the directors' duty statutes. One commentator has referred to them as a "revolution in corporate law."[13] Whether this judgment is accurate must await more judicial and academic attention than the statutes have yet received. Their language is in fact quite malleable. Nevertheless, there is little doubt that the directors' duty statutes present a serious challenge to fundamental assumptions. As a response to broadly shared concerns about the role of the business corporation in our society, they demand to be taken seriously. At the very least, these statutes invite us all — as lawyers, academics, judges, and concerned citizens — to engage in the dialogic process that will determine the direction of corporate law in the years to come.

I. The Shareholder Primacy Principle

The directors' duty statutes are the boldest in a series of recent efforts to reconsider management's role in the corporation. They announce that management, previously accountable to the shareholders by the fiduciary principle, may weigh a broad range of shareholder and nonshareholder interests in making decisions about deployment of the corporation's resources. Before considering these statutes in detail,[14] this section sketches their context, including a discussion of the conventional understanding of the shareholders' position in the corporation,[15] and then of developments that initially signalled a willingness to revise that understanding.[16]

A. The Conventional Understanding

1. Shareholder Primacy.—Corporate management's responsibility typically has been stated in terms of a duty owed to the corporation. Thus,

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13. Hanks, *supra* note 8, at 22.
14. *See infra* pts. II-IV.
15. *See infra* pt. I(A).
16. *See infra* pt. I(B).

for example, the American Law Institute's restatement of the common law duty of care identifies "the best interests of the corporation" as the objective of managerial decision-making.[17] If one thinks of the corporation as an entity embracing a variety of nonshareholder, as well as shareholder, interests, to designate the corporation as the beneficiary of management's activities is potentially vague. How is management supposed to promote a wide variety of possibly conflicting interests? Which is (or are) to have priority?

Corporate law has avoided such puzzles by, for the most part, equating the duty to the corporation with a duty to act in the best interests of its shareholders.[18] Delaware jurisprudence makes this identity explicit by describing management's duty as a duty owed simultaneously "to the corporation and its shareholders."[19] In practice, the view that management is supposed to act in the shareholders' best interests means that it should pursue maximization of the entity's profits in all but exceptional situations; shareholders will benefit in the form of enhanced share values.[20] Thus, under the conventional view, management's duty to act in "the best interests of the corporation" actually means a duty to promote shareholder welfare through profit maximization.[21]

2. Historical Background.—Corporate management's responsibility has not always been defined in terms of shareholder primacy. During much of the nineteenth century, various statutory and common law rules limited management's powers to accumulate wealth for the benefit of the shareholders.[22] The modern view of the corporation as an engine

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17. Principles of Corporate Governance: Analysis and Recommendations § 4.01(a) (Tent. Draft No. 4, 1985) [hereinafter ALI Principles]; *see also* Revised Model Business Corporation Act § 8.30(a) (1984).

18. "[The] phrase ['best interests of the corporation'] is an expression of that component of the duty of loyalty involving the corporate director's primary allegiance. As the shareholders' designee, the corporate director is in a position of stewardship for the owners of the enterprise, whose interests are interchangeably merged with the interests of the corporate entity." *A.B.A. Section of Corporation, Banking and Business Law, Corporate Director's Guidebook*, 33 Bus. Law. 1591, 1601 (1978) [hereinafter *Corporate Director's Guidebook*]; *see also* ALI Principles, *supra* note 17, § 2.01 (corporate objective stated as "enhancing corporate profit and shareholder gain"); ABA Report, *supra* note 8, at 2255 ("With few exceptions, courts have consistently avowed the legal primacy of shareholder interests when management and directors make decisions.").

19. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (1939), *aff'd*, 25 Del. Ch. 363, 19 A.2d 721 (Del. 1941).

20. This is because the corporation's shareholders, whose claims against corporate assets are residual, are entitled to whatever is left after the fixed claims of the corporation's various creditors have been paid.

21. *See* R. Clark, Corporate Law 17-19 (1986).

22. *See* Millon, *Theories of the Corporation*, 1990 Duke L.J. 201, 205-11 [hereinafter Millon, *Theories of the Corporation*].

for shareholder wealth maximization is of relatively recent vintage, connected with changes in thinking about the role of corporations in American society. These changes occurred around the turn of this century, as traditional hostility to corporate accumulation of wealth rapidly eroded.[23] This development was most graphically apparent in the statutory revisions — heralded by New Jersey in 1888[24] — that facilitated the creation of vast holding companies. Thus, it was only during the early years of the twentieth century that the gigantic business corporation assumed its place as a welcome fixture in the American commercial landscape.

As corporations grew in size and share ownership became much more widely dispersed than it had been in the days of smaller, closely-held companies, a class of professional managers emerged who were hired for their special expertise and who typically held minimal stock positions in the firms they managed. Realization of a growing distance between the owners of the corporation and those who managed it first prompted serious attention to the question of management's relation to the corporation's shareholders. This separation of ownership and control raised the danger that corporations might not be managed in the best interests of those who had contributed their capital and were likened to its "owners." The threat was exacerbated by changes in practice that effectively enlarged managerial discretion.[25] In addition, the courts vitiated doctrinal barriers that traditionally had been relied upon to limit corporations to narrow, defined ranges of profit-seeking activity.[26]

Adolf Berle and Gardner Means articulated these concerns with striking force in their classic work published in 1932.[27] They argued that shareholders were owners of property that deserved legal protection. Because of the lack of identity between managerial and shareholder

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23. For discussion of Americans' traditional hostility to concentrations of economic power, see Millon, *The Sherman Act and the Balance of Power*, 61 S. Cal. L. Rev. 1219 (1988). For fuller consideration of changes in thinking about corporations and corporate law that occurred around the turn of this century, see Millon, *Theories of the Corporation*, *supra* note 22, at 211-16; Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 Wash. & Lee L. Rev. 903, 905-18 (1988).

24. Act of Apr. 4, 1888, ch. 269, 1888 N.J. Laws 385; Act of Apr. 7, 1888, ch. 295, 1888 N.J. Laws 445 (allowing corporations to hold stock in other corporations). Removal of traditional statutory limits on capitalization also played an important part in these changes. *See* Millon, *Theories of the Corporation*, *supra* note 22, at 212.

25. Corporate statutes increasingly allowed incorporators to describe corporate purposes and powers in unlimited terms, rather than by means of specific definition. *See* Millon, *Theories of the Corporation*, *supra* note 22, at 208-09, 219.

26. *See id.* at 212 (demise of *ultra vires* doctrine).

27. A. Berle & G. Means, The Modern Corporation and Private Property (1932 & reprint 1948).

interests, such protection depended on effective legal mechanisms for constraining management's use of its discretion in ways that harmed shareholders.[28]

Berle and Means' analysis took for granted that shareholders, as property owners, were entitled to management's undivided loyalty. By 1932, corporate law had already endorsed the view that shareholder financial interests should guide managerial decision-making without regard to competing, nonshareholder claims. As early as 1919, in the oft-quoted *Dodge v. Ford Motor Co.* case,[29] the Michigan Supreme Court repudiated Henry Ford's desire to benefit employees and consumers by sacrificing corporate profits. The court stated a general principle:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.[30]

It was this idea — shareholder primacy in managerial decision-making — that lay at the heart of Berle and Means' influential book.

The history of corporate law since Berle and Means' elaboration of the shareholder primacy idea has consisted largely of efforts to fashion doctrinal solutions to the accountability problem they articulated so forcefully. Such efforts have vacillated between relatively strict and loose responses. Apparent laxity has been the product of judicial and legislative reluctance to second-guess management's expertise[31] and, more recently, to put faith in market forces as more effective policing mechanisms than legal rules.[32] Nevertheless, the underlying premise of the central importance of shareholder welfare has remained unchallenged within mainstream thinking about corporate law.

3. Justifications.—There have been two primary theoretical foundations for the shareholder primacy principle. Traditionally, as Berle and Means contended,[33] notions of property suggested that shareholders,

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28. *Id.*

29. 204 Mich. 459, 170 N.W. 668 (1919) (assessing management policy to use corporate revenues to improve wages and working conditions and to offer the company's product to the public at a lower than profit-maximizing price).

30. *Id.* at 507, 170 N.W. at 684.

31. For discussion of this justification for managerial discretion, see Frug, *The Ideology of Bureaucracy in American Law*, 97 Harv. L. Rev. 1277 (1984).

32. *See infra* text accompanying notes 35-41.

33. A. Berle & G. Means, *supra* note 27.

as the corporation's owners, were entitled to certain legal protections. Along the same line, Berle had earlier described the relation between shareholders and management as a trust relationship, with management holding the shareholders' property in trust for their benefit.[34] The property idea provided a conceptual basis for articulation of rules focusing management's attention on shareholder welfare. The trust analogy was especially apt because, while it referred to the trustee's common law obligation to guard the interests of the beneficiary, it implied broad discretionary powers toward achievement of that objective.

More recently, scholars influenced by neoclassical economic analysis have offered a different explanation for corporate law's requirement that management maximize shareholder financial interests. These scholars have discarded the property notions on which the trust analogy was grounded, finding the ownership idea unhelpful in analyzing the relations among the various participants in the corporate enterprise. Instead, they see the elaborate web of relations that constitutes the large corporation as essentially similar to the relations among actors in a market.[35] Accordingly, the rights of the various participants, including shareholders, managers, and nonshareholders, are better thought of as governed by contractual ordering.[36]

In pursuing their interests through complex arrangements with other suppliers of "inputs," shareholders of large corporations have no choice but to act through professional managers. However, shareholders face the ever-present danger that managers, as agents, will fail to act as diligently as a principal would if acting on his or her own behalf. For shareholders to maximize returns on their investments under these circumstances, the costs of managerial shirking and other forms of misbehavior must be minimized. These costs, together with the costs involved

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34. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

35. For an overview, see Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U.L. REV. 99 (1989). The seminal economic analyses include Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) and Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Examples from the legal literature include Baysinger & Butler, *Anti-Takeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989); *Symposium: Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989). For critical commentary, see Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989); Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 58 TEX. L. REV. 865 (1990).

36. For this reason, this approach to corporate law is often referred to as "the contractual theory of the corporation." *See, e.g.*, Butler, *supra* note 35.

in reducing inefficient behavior, are termed "agency costs."[37] Market forces will tend to reduce agency costs to an efficient level by aligning the interests of shareholders and management,[38] but legal rules also have a role to play because market mechanisms may be insufficient. Thus, various legal doctrines, including the fiduciary duties of care and loyalty,[39] form part of the "standard form contract" between shareholders and management that is supplied by corporate law.[40] From this perspective, management's legal duty to prefer shareholder over other interests is

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37. *See* Jensen & Meckling, *supra* note 35.

38. According to the contractual theory, various market phenomena will have this effect. For example, product market competition will tend to discipline inefficient management. Further, inefficiency will increase capital costs and, because inefficiency will be reflected in share prices, it will invite hostile takeovers in order to install new management that will maximize asset value. *See generally* Butler, *supra* note 35, at 110-20 (discussing these and other market factors). For a vigorous argument against the efficacy of market forces in reducing agency costs, see Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1488-1514 (1989).

39. *See* Butler, *supra* note 35, at 119-20.

40. *Id.* at 119. Several prominent scholars are engaged in a lively debate over the appropriate character of corporate law rules. Some contractualists argue that corporate law rules should represent a standard-form contract governing management's conduct. Shareholders may choose to adopt these rules as a low cost alternative to negotiating and drafting a contract from scratch; however, it is argued, they should also be free to override these rules when they find it in their interest to do so. In other words, corporate law rules should be default or suppletory provisions. *See, e.g.*, Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701, 736 (1987); McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 Colum. L. Rev. 1530, 1535-37 (1989). In contrast, others argue that mandatory rules (*i.e.*, rules that shareholders may not contract around) are necessary to protect shareholders from agency costs. *See* Eisenberg, *supra* note 38.

To the extent this debate is interesting, its appeal is purely academic. First, no one denies that corporate law has always contained mandatory rules (as well as default rules) and there is no sign of any inclination among state legislators to reject the view that mandatory rules are an appropriate part of corporate law. Second, the argument over the desirability of mandatory rules is an argument between camps that share an underlying commitment to shareholder welfare as corporate law's primary objective. The argument is over which approach to corporate law better serves that goal. The mandatory-suppletory debate has nothing to say about why maximization of shareholder welfare (as opposed to some other norm that tempers commitment to that objective in order to accommodate other values) ought to be management's function. The adoption of the new directors' duty statutes indicates the extent to which state legislators are unimpressed with these academic disputations. In most cases, the statutes are mandatory, in the sense that shareholders lack the freedom to avoid their coverage. *But cf. infra* note 103 (discussing "opt-in" statutes). In this regard, corporate law retains the mandatory character it has always had and has never shown any signs of discarding. However, the new statutes' objective is not unalloyed shareholder welfare, but instead some measure of protection for nonshareholder interests in situations in which those interests conflict with shareholders'. In this regard, the new statutes reject the underlying premise on which the proponents of mandatory and suppletory approaches are in accord.

obviously a central element in this implicit bargain. Thus, the new economic theory of the firm replaces older trust and property law ideas as a theoretical explanation for shareholders' legal right to insist on management's exclusive fidelity to their interests.[41]

B. *Initial Inroads*

1. Hostile Takeovers.—Although it appeared to be firmly established, recent events have generated misgivings about shareholder primacy as the fundamental postulate of corporate law. The catalyst has been the immense public policy controversy generated by the proliferation of hostile takeovers during the 1980s. In a typical hostile takeover, the aggressor (or bidder) appeals directly to the target company's shareholders, offering to buy a controlling block of the target's stock at a premium substantially over market price.[42] The great attraction of the hostile takeover by means of tender offer is the bidder's ability to do an "end run" around target company management, who would be expected to resist the bid in order to keep their jobs. An offer's success does not require management approval because the target shareholders possess the power to decide a takeover bid's fate simply by virtue of their right to decide whether to tender their stock to the bidder.

The well-publicized hostile takeovers of the 1980s were, of course, a boon for target company shareholders, who found themselves the beneficiaries of the bidders' remarkable largesse. Takeover premiums, often paid for by readily available junk bond financing, were substantial. Averaging as high as fifty percent,[43] premiums in excess of one hundred

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41. As a normative assertion about the appropriate content of corporate law, the contractualist theory of the corporation rests on a belief in efficiency as the criterion by which legal rules should be evaluated. According to the proponents of the efficiency norm, self-interested bargaining will maximize aggregate wealth in the absence of impediments (market failures or legal rules) to freedom of contract. *See generally* R. Posner, Economic Analysis of Law 11-15 (3d ed. 1986) (discussing efficiency in terms of bargained-for exchange). In the context of corporate law, nonshareholders and shareholders (acting through management, which operates under the shareholder primacy mandate) should pursue their respective interests through private ordering. Unless shareholders agree, legal rules that allow management to temper its commitment to profit maximization with other considerations will threaten efficiency. The directors' duty statutes' apparent rejection of this normative vision and the assumptions on which it is based is discussed *infra* pt. IV(D)(2).

42. For general discussions of the mechanics of hostile takeovers, relevant law, and the attendant policy controversies, see R. Hamilton, Fundamentals of Modern Business 381-414 (1989); L. Solomon & A. Palmiter, Corporations: Examples and Explanations 533-44, 551-89 (1990).

43. *See supra* note 3.

percent were not uncommon.[44] Moreover, economic theorists argued that all shareholders — even those whose corporations were never pursued by hostile bidders — benefitted in another less dramatic, but no less significant, way from a robust market for corporate control. The looming threat of a hostile takeover spurs corporate managers to eliminate slack and otherwise increase corporate profitability: Management's failure to maximize the value of the firm's assets will be reflected in depressed stock prices, which will invite a takeover by someone eager to install a more efficient management team.[45]

In the public's eyes, the dark side of these impressive gains for shareholders has been the adverse effects on nonshareholders. The use of enormous amounts of credit to finance these acquisitions creates strong pressures to cut costs, and, in some cases, prompts asset liquidations and plant closings. Particularly with regard to bust-up takeovers,[46] it is often assumed that dramatic employee layoffs will follow. Given the usual unavailability of a right to compensation, layoffs of employees, who have invested years of their lives in their jobs, are widely perceived to frustrate legitimate expectations of employment security.[47]

The economic theory of implicit labor contract provides a useful perspective on this problem. According to this theory, entry-level employees starting a new job typically agree to work for less than the full value of their contribution to the firm in exchange for an implicit promise of job security and increased compensation in the future. In return for undertaking to reduce the risk of unemployment facing the employee, the employer can better encourage the employee to make firm-specific investments of human capital (such as acquisition of specialized skills) that he or she otherwise would be reluctant to make because they are not readily transferrable to a new job in the event of layoff. The deferred aspect of the compensation arrangement also motivates the junior employee to work diligently in the expectation of future pay-offs. These mutual undertakings are implicit elements of the contractual bargains struck between employees and employers, but they are not explicitly articulated and therefore not legally enforceable. Accordingly, the value

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44. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1259 n.126 (1990).

45. *See* Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

46. *See supra* note 4.

47. For discussion of the problem of plant closings and an extended argument in favor of legal protection from job losses, see Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988). Singer argues for recognition of rights growing out of reliance on relationships, as opposed to the traditional limitation of reliance-based recovery to reliance on promises. *See id.* at 663-701.

of these expectations to the employee depends on the employer's willingness to honor them. Although employers may generally be disinclined to breach this trust (for reputational and employee morale reasons), shareholders whose corporation is the subject of a hostile tender offer are able to behave opportunistically toward the firm's employees by selling the firm to a bidder that will cut costs by reneging on implicit contracts. Thus, layoffs in the wake of a takeover may represent repudiation of legitimately relied upon expectations of continued employment for which no compensation is available.[48]

Employees are not the only nonshareholder constituency believed to suffer unfairly from hostile takeovers. Customers and suppliers may have made investments whose value depends on the continuation of legitimately expected long-term relationships, and increased indebtedness places preexisting creditors in a more precarious position than they were in before the takeover. Local communities in which corporate divisions have operated for years may lose tax revenues and charitable contributions on which they have come to depend, and find themselves saddled with costly public works projects (like roads, schools, or hospitals) undertaken in the expectation of the corporation's continued presence in the community. Even when companies avoid being taken over by resorting to radical financial restructuring, the increased debt burden may result in all of these various nonshareholder groups sustaining losses similar to those that follow successful takeovers.

2. Judicial and Legislative Responses.—Public perceptions about the harmful effects of hostile takeovers on nonshareholders have encouraged a series of assaults on the shareholder primacy principle in the takeover context. State courts have been increasingly willing to allow target company management to block unwelcome takeover bids, even when the bid might be lucrative enough to appeal to target shareholders. In some cases, courts have allowed target management to justify such measures by claiming to protect shareholder interests. Even though this sort of paternalism prevented shareholders from deciding for themselves whether

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48. Though senior executives may enjoy "golden parachute" arrangements, rights to severance payments are uncommon for lower-level employees. For discussions of the implicit contract idea and its relevance to the issues discussed here, as well as citations to the economic literature, see Coffee, *supra* note 4; Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173; O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, forthcoming in N.C.L. REV. (1991). It has been argued that takeover premiums paid to target company shareholders derive at least in part from bidders' ability to renege on implicit promises of long-term job security. *See* A. Schliefer & L. Summers, *Breach of Trust in Hostile Takeovers*, Nat'l Bureau of Economic Research Working Paper No. 2342 (August 1987).

to tender their stock,[49] courts at least paid lip service to shareholder primacy. In the important *Unocal* case,[50] however, the Delaware Supreme Court suggested that shareholder primacy may not be the rule in the hostile takeover setting. In that case, the court stated that a board of directors deciding whether to block a hostile bid might justify defensive measures by taking into account "the impact [of the takeover] on 'constituencies' other than shareholders (*i.e.*, creditors, customers, employees, and perhaps even the community generally)."[51] Delaware's judiciary has since reiterated this idea,[52] and courts in other jurisdictions have made similar pronouncements.[53] Nevertheless, the extent to which courts in Delaware and elsewhere are willing to allow target management explicitly to subordinate shareholder to nonshareholder interests has been unclear. In the only case squarely presenting the issue, the Delaware Supreme Court held that under the circumstances, management's sole responsibility was to maximize share value.[54]

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49. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (allowing management's deployment of poison pill designed to protect shareholders from unfair tender offer bids). Although it purports to rest on an underlying commitment to shareholder welfare, the shareholder protection rationale for management defensive action differs from a shareholder autonomy interpretation of shareholder welfare because an autonomy approach would leave shareholders with the power to define their welfare for themselves. For discussion of shareholder protection and shareholder autonomy as alternative and potentially conflicting interpretations of shareholder welfare in the context of target management defensive measures, see Johnson & Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1882-86 (1989) [hereinafter Johnson & Millon, *Misreading the Williams Act*].

50. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

51. *Id.* at 955.

52. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), the court referred to the board's prerogative to consider nonshareholder interests, but added that "there must be some rationally related benefits accruing to the stockholders." *Id.* at 176; *see also* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1987). However, in Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341-42 (Del. 1987), the court reiterated *Unocal*'s declaration of the relevance of nonshareholder considerations in hostile takeovers, without *Revlon*'s qualification. More recently, Chancellor William Allen has written that "directors in pursuit of long run corporate (and shareholder) value may be sensitive to the claims of other 'corporate constituencies.'" TW Services, Inc. v. SWT Acquisition Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 (Del. Ch. 1989).

53. For statements endorsing management consideration of nonshareholder interests, see Herald Co. v. Seawell, 472 F.2d 1081, 1091 (10th Cir. 1972); Baron v. Strawbridge & Clothier, 646 F. Supp. 690, 697 (E.D. Pa. 1986); GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985); Enterra Corp. v. SGS Assoc., 600 F. Supp. 678, 689 (E.D. Pa. 1985).

54. *See Revlon*, 506 A.2d 173 (holding that situation required target company management to auction the company to the highest bidder in order to maximize share value); *cf.* City Capital Assocs. v. Interco, 551 A.2d 787 (Del. Ch. 1988) (requiring

Although state courts have exhibited ambivalence about the legitimacy of explicitly decentering shareholder interests in takeover contests, the Delaware judiciary seemed particularly sympathetic to that objective in the recent widely publicized *Paramount Communications, Inc. v. Time, Inc.* case[55] — though, ironically, the supreme court's opinion purported to endorse shareholder primacy. The judgments in *Time* approved Time management's efforts to fend off Paramount's unwelcome bid by restructuring a negotiated merger with Warner in a manner that denied Time shareholders a right to vote.[56] The object of this tactic was to foreclose the likely possibility that Time's shareholders would vote against the merger in order to accept Paramount's tender offer premium, which started high and soon exceeded one hundred percent.[57] Time's projections for the value to its shareholders of the Time-Warner combination were strong, though necessarily vague and highly speculative.[58] In addition, Time management emphasized the importance of a distinctive "Time culture" of editorial independence and journalistic integrity,[59] said to be crucial to the magazine's role in the cultivation of an informed, politically astute citizenry. An acquisition by Paramount would have placed "Time culture" in jeopardy.[60]

The Delaware Supreme Court affirmed the trial court's refusal to enjoin preliminarily the Time-Warner combination, purportedly on the

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management redemption of poison pill to allow shareholders to choose whether to accept noncoercive tender offer; no reference to possible harm to nonshareholder constituencies). For a thoughtful commentary on the Delaware judiciary's vacillating commitment to shareholder primacy in the takeover setting, see Johnson, *supra* note 35, at 910-33.

55. Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989), *aff'd*, 571 A.2d 1140 (Del. 1990).

56. *Id.*

57. Paramount's initial offer, to buy all outstanding shares at $175, was later increased to $200. At the time of the first announcement, Time stock was trading at $126. *Time*, 571 A.2d at 1147-49.

58. Time's advisers offered the following ranges: between $106-$188 for 1990, $159-$247 for 1991, $230-$332 for 1992, and $208-$402 for 1993. In Chancellor Allen's words, the last range in particular was one "that a Texan might feel at home on." *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,273.

59. *See Time*, 571 A.2d at 1143 n.4; *see also Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,267-69.

60. Time director Matina S. Horner, then president of Radcliffe College, described the public interest aspect of "Time culture" in these terms:

> I am very concerned about the need to preserve Time's editorial freedom. I believe that editorial freedom free from political or other kinds of intervention is absolutely essential if members of our society are to be enlightened enough to form wise judgments and fulfill their responsibilities as citizens. I believe that the need to foster a literate citizenry is the *sine qua non* of this nation's and the company's future.

Time, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,269.

ground that Time's management was legitimately seeking to serve shareholder interests.[61] However, because the long-term financial benefits of the Warner agreement were uncertain and the shareholders could be presumed to have preferred the short-term alternative of a Paramount acquisition, the facts did not present a strong instance of blocking tactics undertaken to protect shareholder welfare. The court did refer to Time management's duty to protect its shareholders from harmful tender offer bids, but the asserted threats to shareholder welfare were so inconsequential that it is hard to take seriously shareholder protection as the dominant justification for the court's holding.[62]

Although purporting to rely on conventional shareholder primacy rhetoric, the broad power to block unwelcome takeovers that *Time* endorses instead suggests a very different justification for the result. Shareholders effectively lose the benefits of an active takeover market in exchange for the Delaware Supreme Court's authorization of broad managerial prerogative to chart the corporation's course. Thus, the court spoke approvingly of management's discretion to prefer long-term corporate strategies over short-term shareholder gains.[63] Because the court is silent, we are left to speculate about what underlying values legitimate management's authority to pursue such long-range strategies. Shareholder welfare itself would not seem to be among those values because the premise underlying the case was Time shareholders' preference for the short-term gains offered by Paramount. The references to corporate benefit and denigration of short-term shareholder gains suggest instead that the beneficiary of the court's decision is supposed to be the corporate enterprise as a whole, distinct from its shareholders. Beneath this conception may be a continued adherence to the importance of profit maximization, but only so long as it is pursued through preservation of stable relations among the firm's various constituencies.[64] Further, the "Time culture" idea may suggest the legitimacy of the public's interest in the preservation of corporate independence when necessary to protect legitimately valued business policies.[65]

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61. *Time*, 571 A.2d at 1142.

62. Because Paramount's bid was an all-cash, all-shares offer, the threat of shareholder coercion presented by a two-tier bid was not present. Nor was the bid obviously too low. Instead, the court referred to the danger that Time shareholders might be ignorant or confused about the respective merits of the alternatives before them and that the conditions attached to the offer would make it hard to evaluate. *See id.* at 1153. Needless to say, the same might be said about most hostile tender offers.

63. *Id.* at 1150.

64. For a reading of the *Time* opinions that analyzes their destabilizing effects on existing legal doctrine, see Johnson & Millon, *Case Beyond* Time, *supra* note 6.

65. For a reading of *Time* that discusses the nonshareholder considerations —

Alongside these common law developments, most states have enacted statutes that restrict hostile takeovers in various ways.[66] After the United States Supreme Court struck down Illinois's takeover regulation statute on commerce clause grounds in 1982,[67] state legislatures returned to the drawing board in order to develop new strategies. The result has been various forms of antitakeover statutes that are packaged as instances of the states' traditional jurisdiction over corporate internal affairs.[68] One such statute, the control share acquisition statute, passed constitutional muster in *CTS v. Dynamics Corp. of America*[69] and has been widely adopted.[70] The more potent business combination statute also has survived constitutional challenge.[71] The aim of these and other legislative efforts is to protect the interests of those nonshareholders who must bear the costs of unrestricted takeover activity.[72] While the judiciary has exhibited an ambivalent stance toward restriction of shareholder rights in hostile takeovers, the state legislatures have acted much more forthrightly.

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particularly a public interest idea — that may lie beneath its conventional rhetoric, see Millon, *Theories of the Corporation*, *supra* note 22, at 251-61. Professor Johnson argues that judges confronting important corporate law questions inescapably do so from a public policy perspective. *See* Johnson, *supra* note 35.

66. For a general discussion of the various species of antitakeover legislation, see Johnson, *supra* note 5, at 61-88. The Investor Responsibility Research Center Inc. publishes an up-to-date record of state antitakeover legislation. P. McGurn, S. Pamepinto & A. Spector, State Takeover Laws (1989 & Supp. June 30, 1990) [hereinafter IRCC, State Takeover Laws].

67. Edgar v. MITE Corp., 457 U.S. 624 (1982).

68. For discussion of this "corporatization" strategy, see Johnson & Millon, *Misreading the Williams Act*, *supra* note 49, at 1873-82.

69. 481 U.S. 69 (1987).

70. Control share acquisition statutes condition a hostile bidder's voting rights on approval by the target company shareholders. For an up-to-date listing, with citations, see IRCC, State Takeover Laws, *supra* note 66.

71. Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir. 1989) (upholding Wisconsin's business combination statute), *cert. denied*, 110 S. Ct. 367 (1989); RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476 (D. Del. 1988) (Delaware's statute); Vernitron Corp. v. Kollmorgen Corp., No. 89 Civ. 241 (S.D.N.Y. 1989) (New York's statute). Several states besides Delaware, New York, and Wisconsin have adopted business combination statutes. *See* IRCC, State Takeover Laws, *supra* note 66. Business combination statutes restrict a hostile bidder's rights to engage in certain significant post-takeover transactions unless target company management previously approved the acquisition or the transaction.

72. For a discussion of the motivations behind state takeover legislation, see Johnson & Millon, *Missing the Point*, *supra* note 7. *But see* Booth, *The Promise of State Takeover Statutes*, 86 Mich. L. Rev. 1635 (1988) (analyzing benefits to shareholders of control share acquisition statutes); Romano, *The Political Economy of Takeover Statutes*, 73 Va. L. Rev. 111 (1987) (arguing that management interests are primary motive force behind antitakeover legislation).

The effectiveness of judicial and legislative efforts to halt the takeover boom is still uncertain. Other factors, such as the withering junk bond market, may bring about that result on their own.[73] Nevertheless, these efforts are significant for what they tell us about the security of the shareholder primacy principle. They indicate a willingness to subordinate shareholder financial interests to the interests of nonshareholders and of the corporate entity's longer-term viability, at least in the hostile takeover context. Explicit rhetoric, implicit motivation, and actual results make this interpretation unmistakable. Though these efforts are thus far limited to the specific context of hostile takeovers, it is important to see that the takeover market is perhaps the single area in which shareholder primacy is most important. After all, that is where shareholders stand to reap the rewards of windfall premiums, as well as the less dramatic benefits to be derived from enhanced managerial diligence. Thus, the states' judicial and legislative willingness to place restrictions on the market for corporate control represents an important prelude to the frontal assault on shareholder primacy apparent in the directors' duty statutes.

II. The Directors' Duty Statutes

A. *The Statutes*

Although recent judicial and legislative restrictions on hostile takeovers suggest at least a partial willingness to subordinate shareholder to nonshareholder interests, the proliferation of state statutes redefining management's duties reveals this policy much more graphically. In various forms, these statutes authorize management[74] to consider shareholder as well as nonshareholder interests in formulating corporate policies. On their face, the statutes appear to deny shareholders the right to insist on management's undivided devotion to their financial welfare, and may also acknowledge nonshareholders' right to management's attention.[75]

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73. A respected commentator has stressed the importance of junk bond financing to the takeover boom. *See* Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. Pa. L. Rev. 1, 11-13 (1987).

74. Most of the statutes refer to directors' duties. As such, they apply to senior officers who sit on the board as well as to outside directors. A few also apply to officers who are not directors. *See, e.g.*, Ill. Ann. Stat. ch. 32, ¶ 8.85 (1989), *as amended by* Pub. Act 86-126, 1989 Ill. Legis. Serv. 1314 (West); Me. Rev. Stat. Ann. tit. 13-A, § 716 (Supp. 1989); Wis. Stat. Ann. § 180.305 (West Supp. 1989).

75. These questions are considered in detail *infra* pts. III & IV.

Nearly thirty states have adopted some form of this new directors' duty statute.[76]

As discussed previously, management's duty to the corporation has been defined in terms of a duty to maximize corporate profits for the benefit of the shareholders.[77] Until the hostile takeover boom, it was rarely necessary to consider situations in which the interests of the corporate entity (including the various participants in the corporate enterprise) and those of the shareholders alone might diverge.[78] For the most part, one could safely assume that corporate profitability would benefit nonshareholders as well as shareholders. Especially in times of general prosperity, larger pies imply larger servings for all. Accordingly, there have been very few cases in which courts have been called upon to consider whether, if profit maximization threatens nonshareholder interests, management might lawfully choose to temper its devotion to shareholder welfare.[79]

Yet the legal description of management's duty as a duty owed to the corporation[80] contains a potential ambiguity. Although this duty has been interpreted as synonymous with a duty to maximize share values,[81]

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76. ARIZ. REV. STAT. ANN. § 10-1202(A) (1990); CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1990); FLA. STAT. ANN. § 607.111(9) (West Supp. 1990); GA. CODE ANN. § 14-2-202(5) (1989); HAW. REV. STAT. § 415-35(b) (Supp. 1990); IDAHO CODE § 30-1602 (Supp. 1990); ILL. ANN. STAT. ch. 32, ¶ 8.85 (Smith-Hurd Supp. 1990), *as amended by* Pub. Act 86-126, 1989 Ill. Legis. Serv. 1314 (West); IND. CODE ANN. § 23-1-35-1(d)(f)(g) (West Supp. 1990), *as amended by* Pub. Law 227-1989 (approved Feb. 23, 1989); IOWA CODE ANN. § 490.1108 (West 1990); KY. REV. STAT. ANN. § 271B.12-210(4) (Michie/Bobbs-Merrill Supp. 1990); LA. REV. STAT. ANN. § 12:92(G) (West Supp. 1991); ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1990); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 1990); MINN. STAT. ANN. § 302A.251(5) (West Supp. 1991); MISS. CODE ANN. § 79-4-8.30 (Supp. 1990); MO. ANN. STAT. § 351.347 (Vernon Supp. 1991); NEB. REV. STAT. § 21-2035(1) (Supp. 1988); N.J. STAT. ANN. § 14A:6-14(4) (West Supp. 1990); N.M. STAT. ANN. § 53-11-35(D) (Supp. 1989); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1991); OHIO REV. CODE ANN. § 1701.59 (Anderson Supp. 1989); OR. REV. STAT. § 60.357(5) (1989); PA. CONS. STAT. ANN. §§ 511(d),(e),(g) & 1721(e),(f),(g) (Purdon Supp. 1990); R.I. GEN. LAWS § 7-5.2-8 (Supp. 1990); S.D. CODIFIED LAWS ANN. § 47-33-4 (Supp. 1990); TENN. CODE ANN. § 48-35-204 (Supp. 1988); WIS. STAT. ANN. § 180.305 (West Supp. 1990); WYO. STAT. § 17-16-830 (1989). Notable among the states that have not adopted directors' duty statutes are Delaware and California. IRCC, STATE TAKEOVER LAWS, *supra* note 66, continuously monitors legislative activity and is a good source for locating additional statutes enacted since this Essay went to press.

77. *See supra* pt. I(A)(1).

78. *See generally* Johnson, *Corporate Takeovers and Corporations: Who Are They For?*, 43 WASH. & LEE L. REV. 781 (1986).

79. For notable exceptions, see *supra* text accompanying notes 29-30 (discussing *Ford* case) and *infra* note 119 (discussing *Wrigley* case).

80. *See supra* text accompanying note 17.

81. *See supra* text accompanying notes 18-21.

there has always been the latent possibility that the duty to the corporation might be interpreted as a duty to consider the welfare of the enterprise as a whole, including all of its constituent participants, rather than as a sharply focused duty to promote shareholder welfare to the exclusion of other considerations. The hostile takeover explosion fractured the complacently assumed unity of interest between the corporate entity and shareholders. As shareholders reaped unprecedented returns, lost jobs and other costly, highly publicized side effects focused attention on the fact that shareholder welfare did not necessarily imply corresponding benefits for nonshareholders. Indeed, the opposite might be the case. Accordingly, state courts and legislatures have been forced to define management's duty with more precision.[82] This process began with the judicial[83] and legislative[84] developments traced above and finds its most direct expression in the new directors' duty statutes.

In form, the directors' duty statutes specify the interests that directors may legitimately weigh in performing their managerial functions. Ironically, they do this while, for the most part, clinging to the traditional formulation of management's duty as owing to the corporation or even to the corporation and its shareholders. Nevertheless, the new statutes clearly reject shareholder primacy as the guiding principle. For example, Maine's statute refers to the responsibility to make business decisions according to "the best interests of the corporation and of its shareholders"[85] but then specifies that directors may "consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors."[86] Other statutes similarly refer to the standard duty to the corporate entity and its shareholders, but add that "long-term" considerations as well as nonshareholder interests are also relevant:

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82. Recently, Delaware Chancellor William Allen lucidly stated the ambiguity latent in the board's duty to "the corporation and its shareholders":

> The knowledgeable reader will recognize that this particular phrase masks the most fundamental issue: to what interest does the board look in resolving conflicts between interests in the corporation that may be characterized as "shareholder long-term interests" or "corporate entity interests" or "multi-constituency interests" on the one hand, and interests that may be characterized as "shareholder short-term interests" or "current share value interests" on the other?

TW Services, Inc. Shareholders Litigation, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 n.5 (Del. Ch. 1989).

83. *See supra* text accompanying notes 49-65.

84. *See supra* text accompanying notes 66-72.

85. Me. Rev. Stat. Ann. tit. 13-A, § 716 (Supp. 1990).

86. *Id.* For a similar formulation, which is limited to hostile or friendly corporate combinations, see La. Rev. Stat. Ann. § 12:92(G) (West Supp. 1991).

> In discharging his [or her] duties, a director may consider such factors as the director deems relevant, including the long-term prospects and interests of the corporation and its shareholders, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the corporation or its subsidiaries, the communities and society in which the corporation or its subsidiaries operate, and the economy of the state and nation.[87]

According to statutes like this one, directors are not only free to consider the listed nonshareholder interests, they may also decline to take action that would be immediately profitable to shareholders in order to pursue possible longer-term benefits.[88] Presumably, shareholders need not be the primary beneficiaries of these longer-term strategies. Yet another statutory approach characterizes management's duty simply as a duty owed to the corporation as an entity, but includes shareholder interests as only one among a longer list of relevant considerations.[89]

All directors' duty statutes share the apparent objective of allowing management to consider nonshareholder interests in running the corporation. In this respect, they reject the traditional principle that management's attention should focus solely on shareholder financial welfare. However, the statutes typically offer little, if any, guidance about how management is to exercise this new power. This feature raises important questions: Is there any duty to consider shareholder interests at all? Can management make decisions bearing on nonshareholder interests with complete disregard for shareholder welfare? Or, alternatively, can management choose to ignore nonshareholder interests in order to promote the traditional objective of shareholder welfare? If management chooses to weigh both shareholder and nonshareholder interests, what weight is each to receive in cases of conflict?

Ohio's statute is one of the few that expressly makes consideration of shareholder interests mandatory:

> [A] director, in determining what he [or she] reasonably believes to be in the best interests of the corporation, shall consider the

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87. FLA. STAT. ANN. § 607.111(9) (West Supp. 1990).

88. *See* CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1990); HAW. REV. STAT. § 415-35(b) (Supp. 1990); IDAHO CODE § 30-1602 (1989); IOWA CODE ANN. § 490.1108 (West 1990); KY. REV. STAT. ANN. § 271B.12-210(4) (Michie/Bobbs-Merrill 1990); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 1990); MINN. STAT. ANN. § 302A.251(5) (West Supp. 1989); N.M. STAT. ANN. 53-11-35(D) (Supp. 1989); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1991); OR. REV. STAT. § 60.357(5) (1989).

89. IND. CODE ANN. § 23-1-35-1(d),(f),(g) (West Supp. 1990), *as amended by* Pub. Law 227-1989 (approved Feb. 23, 1989); WIS. STAT. ANN. § 180.305 (West Supp. 1990).

> interests of the corporation's shareholders and, in his [or her] discretion, may consider any of the following:
>
> (1) The interests of the corporation's employees, suppliers, creditors, and customers;
>
> (2) The economy of the state and nation;
>
> (3) Community and societal considerations.[90]

In most other cases, there is no explicit requirement that management assign any significance to shareholder interests. Thus, most of the directors' duty statutes apparently confer broad discretion on management to decide whether to take shareholder interests into consideration at all.[91]

In contrast, Connecticut's statute is the only one that makes consideration of nonshareholder interests mandatory:

> [A] director . . . shall consider, in determining what he [or she] reasonably believes to be in the best interests of the corporation, (1) the long-term as well as the short-term interests of the corporation, (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation, (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations including those of any community in which any office or other facility of the corporation is located. A director may also in his [or her] discretion consider any other factors he [or she] reasonably considers appropriate in determining what he [or she] reasonably believes to be in the best interests of the corporation.[92]

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90. Ohio Rev. Code Ann. § 1701.59 (Baldwin Supp. 1989); *see also* Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990); N.M. Stat. Ann. § 53-11-35(D) (Supp. 1989).

91. A few statutes refer to the interests of the corporation as an entity and of various nonshareholder constituencies, but actually omit any direct reference to shareholders in specifying management's responsibility. *See* Ill. Ann. Stat. ch. 32, ¶ 8.85 (Smith-Hurd Supp. 1990), *as amended by* Pub. Act 86-126; Mo. Ann. Stat. § 351.347 (Vernon Supp. 1990). Tennessee's law is phrased as an exemption from liability for good faith consideration of enumerated nonshareholder interests and therefore says nothing about shareholder interests. Tenn. Code Ann. § 48-35-204 (1988). Despite the absence of direct references, however, it seems highly unlikely that these legislatures intended actually to exclude shareholder interests from the realm of legitimate management discretion; these would no doubt be included among unspecified "pertinent factors" or be subsumed within the reference to the interests of the corporate entity.

92. Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990). Arizona's statute, Ariz. Rev. Stat. Ann. § 10-1202(A) (1990), does not explicitly refer to nonshareholder constituencies but does require directors to consider the "long-term as well as short-term interests of the corporation and its shareholders." This reference might be interpreted as a requirement that management consider effects on nonshareholders as well as shareholder interests in short-term gains.

The rest would appear to leave management free to give no weight to nonshareholder interests and instead attend solely to shareholders.

Questions concerning what the directors' duty statutes allow or require of management are complicated and will be discussed below in detail.[93] For now, it is enough to note that, on their face, the statutes appear to confer extremely broad discretion. Most of them seem to allow management to decide which among the array of potentially relevant shareholder and nonshareholder interests should guide decision-making. There is no express requirement that either shareholder or nonshareholder considerations be taken into account in any particular case. This suggests that management may legitimately choose to focus its attention on one or the other. Likewise, management may be free to concern itself with only one or a few nonshareholder constituencies, to the exclusion of other conflicting nonshareholder interests. The statutes' only apparent substantive limitation on management's freedom to choose the beneficiaries of its decision-making is an implicit one, and would require that management seek to further some statutorily enumerated shareholder or nonshareholder interest, as opposed to the interest of some nonshareholder constituency (such as management's self-interest) beyond the range of interests articulated by the statute.

Superficially, at least, this broad freedom (to decide which interests to consider) seems to imply further that management also has the discretion to decide the respective weight to be accorded the various shareholder or nonshareholder interests it chooses to consider. If a statute implies that no constituency can insist on being considered at all, it may also imply that none may demand that it receive priority should management choose to consider it. Two statutes appear to contain clear language to this effect. Indiana's statute expressly provides that in considering the best interests of the corporation, directors are free to take into account effects on enumerated nonshareholder constituencies as well as on shareholders.[94] It goes on to state that "directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor."[95] Pennsylvania recently has amended its directors' duty statute to include similar language.[96] Though lacking express provision to this

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93. *See infra* pts. III & IV.

94. Ind. Code Ann. § 23-1-35-1(d) (West Supp. 1990), quoted *supra* in text accompanying note 1.

95. *Id.* § 23-1-35-1(f).

96. "[T]he board of directors . . . shall not be required . . . to regard any corporate interest or the interest of any corporate group as a dominant or controlling interest or factor." Pa. Cons. Stat. Ann. § 511(b) (Purdon Supp. 1991); *cf.* N.Y. Bus. Corp. Law § 717(b) (McKinney Supp. 1990) ("Nothing in this paragraph shall create any duties owed

effect, it may be possible to read most of the directors' duty statutes[97] as implying the same idea.

The broad powers granted to management by the directors' duty statutes extend, in most cases, across the entire spectrum of managerial decision-making.[98] A few apply only to takeovers or other change of control transactions,[99] reflecting the background against which they were adopted. Others, however, include references to the takeover context, but clearly indicate that they apply generally to director decision-making. Illinois's statute, for example, authorizes directors to consider the effects on nonshareholders "of any action (including without limitation, action which may involve or relate to a change or potential change of control of the corporation)."[100] Similarly, Indiana's statute, while speaking in general terms about the directors' authority to consider shareholder as well as nonshareholder interests,[101] also includes an explicit statement disaffirming any duty to act or decline to act in the interest of any shareholder or nonshareholder constituency "solely because of the effect such action might have on a proposed acquisition of control of the corporation or the amounts that might be paid to shareholders under such an acquisition."[102] Most of the remaining statutes say nothing about takeovers or any other specific contexts to which they might apply.[103]

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by any director to any person or entity to consider or afford any particular weight to any of the foregoing [specified nonshareholder constituencies.]").

97. That is, all but those that expressly make consideration of either shareholder or nonshareholder interests mandatory. *See supra* notes 90 & 92 and accompanying text.

98. In a few cases, coverage is limited to publicly held corporations, defined according to stated criteria. *See* Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990); Idaho Code § 30-1602 (Supp. 1990).

99. *See* Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990); Iowa Code Ann. § 490.1108 (West Special Pamphlet 1990); La. Rev. Stat. Ann. § 12:92(G) (West Supp. 1990); Mo. Ann. Stat. § 351.347 (Vernon Supp. 1990); Or. Rev. Stat. § 60.357(5) (1989 & Supp. 1990); Tenn. Code Ann. § 48-35-204 (Supp. 1990).

100. Ill. Ann. Stat. ch. 32, ¶ 8.85 (Smith-Hurd Supp. 1990); *see also* Ky. Rev. Stat. Ann. § 271B.12-210(4) (Michie/Bobbs-Merrill Supp. 1989 & Supp. 1990); Mo. Ann. Stat. § 351.347 (Vernon Supp. 1990); N.J. Stat. Ann. § 14A:6-14(4) (West Supp. 1990); N.Y. Bus. Corp. Law § 717(b) (McKinney Supp. 1991).

101. Ind. Code Ann. § 23-1-35-1(f) (West Supp. 1990).

102. *Id.*

103. *See* Fla. Stat. Ann. § 607.111(9) (West Supp. 1990); Haw. Rev. Stat. § 415-35(b) (Supp. 1990); Me. Rev. Stat. Ann. tit. 13-A, § 716 (1981 & Supp. 1990); Mass. Gen. Laws Ann. ch. 156B, § 65 (West Supp. 1990); Minn. Stat. Ann. § 302A.251(5) (West Supp. 1991); Neb. Rev. Stat. § 21-2035(1) (Supp. 1988); Ohio Rev. Code Ann. § 1701.59 (Anderson Supp. 1989); Pa. Cons. Stat. Ann. § 511(b) (Purdon Supp. 1990).

All but a few of the statutes apply automatically. None allows shareholders (or nonshareholders for that matter) to agree to waive (or "opt out" of) the statutory authorization to consider nonshareholder interests and substitute a shareholder primacy rule instead. In this sense, although most do not require management to protect non-

B. The Structure Of Corporate Governance

Despite their apparent iconoclastic ambitions, the statutes leave untouched some basic features of existing corporate legal structure. Most obviously, management remains at the top of the corporation's decision-making hierarchy. If state legislatures were motivated by solicitude for nonshareholders, they conceivably might have established a quite different governance structure. For example, nonshareholders might be given the right to participate directly in high level decision-making, at least with respect to matters in which they have an immediate interest. Toward this end, corporations might be required to set aside particular seats on the board of directors for representatives of various nonshareholder constituencies.[104] Or, more radically, one might revise the customary decision-making hierarchy by diffusing power downward from management into the hands of particular nonshareholder constituencies most likely to be affected by particular decisions. The statutes do not seek to promote nonshareholder interests in these ways.

Furthermore, the directors' duty statutes do nothing to alter the existing electoral system. In this respect, management remains accountable only to the shareholders. This may seem surprising: If the legislatures expected management to look after nonshareholder interests, one might have thought the statutes would attempt to achieve accountability by providing nonshareholders with the right to participate in the annual election of the board of directors.[105] This, of course, is the rationale behind shareholder voting rights. Yet the directors' duty statutes say nothing about voting rights for nonshareholders.[106]

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shareholders, the new statutes are "mandatory." *See supra* note 40. A few, however, merely allow corporations to "opt in" by including a new directors' duty provision in the articles of incorporation. *See* Ga. Code Ann. § 14-2-202(5) (1989); Tenn. Code Ann. § 48-35-204 (1988). Because articles amendments typically require shareholder approval, "opt-in" directors' duty statutes seem odd: Would rational shareholders ever agree to such provisions if given the chance to vote against them? In fact, at least two such proposals, both involving Georgia corporations, have been adopted. ABA Report, *supra* note 8, at 2263 n.35. While these events may be explained by management's control of the proxy machinery, it would be wrong simply to assume that management seeks to further its own self-interest in such situations. It is conceivable that management desires the broader powers conferred by the directors' duty provisions because they better comport with management's views about responsible conduct of corporate operations.

104. *See, e.g.*, R. Nader, M. Green & J. Seligman, Taming the Giant Corporation (1976).

105. Compare German corporate law, which mandates employee participation (with shareholders) in election of the board of directors. *See generally* Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. Comp. Corp. L. & Sec. Reg. 155 (1982).

106. *See infra* pt. IV(B) for further discussion of this and related issues.

To the extent the statutes do attempt to protect nonshareholder interests, they rely on a traditional conception of the role of corporate management. That is, just as management has been the vehicle for achievement of the goal of shareholder welfare, now, as the objective apparently changes to embrace nonshareholder welfare as well, management takes on that responsibility. Facially, the statutes leave open the question of management's status as fiduciary. Is it still appropriate to conceive of management as owing a fiduciary duty, albeit qualified, to the corporation's shareholders? Is management's new responsibility to nonshareholders fiduciary in nature? Before these questions can be addressed, it is necessary to consider in more detail how the new statutes alter existing shareholder and nonshareholder rights.

III. Decentering Shareholders

The new directors' duty statutes appear to allow management to consider the impact of its decisions on nonshareholder interests and, if deemed appropriate, to choose courses of action that are inconsistent with traditional notions of shareholder primacy. Decentering the shareholder in this manner might be termed the negative aspect of the statutory agenda: The directors' duty statutes take away a basic right — shareholder primacy in managerial decision-making — previously provided by corporate law.[107] But what sort of legal regime do the statutes contemplate instead? What new rights do nonshareholders gain? What is management supposed to do with its newly minted discretion? Postponing for the moment consideration of such questions, which we might call the affirmative side of the new directors' duty statutes,[108] this section analyzes their negative aspect.

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107. In referring to the statutes' "negative" aspect, I do not mean to imply an evaluative judgment. Rather, my point is to distinguish between, on the one hand, the way in which they diminish or reduce existing legal protection for shareholders and, on the other, enhance or increase the status of nonshareholders. The latter is what I mean by the statutes' "affirmative" agenda, considered in Part IV below. Professor Johnson has analyzed both the negative and the positive aspects of judicially imposed restrictions on shareholders' right of access to tender offers in terms of redefinition of the attributes of corporate stock. That is, protection for nonshareholders has been achieved by cutting back existing shareholder "property" rights rather than by articulating new rights (based on property, contract, or tort, for example) on behalf of nonshareholders. *See* Johnson, *supra* note 35, at 888 n.86; *see generally* Johnson, *Sovereignty Over Corporate Stock*, forthcoming in Del. J. Corp. L. (1991). Considering the question beyond the specific context of hostile takeovers, I argue below that adequate protection for nonshareholders cannot be achieved solely through restriction of shareholder rights; instead, affirmative responsibilities must be imposed on management to protect nonshareholder interests. *See infra* pts. IV(B), (C). For discussion of the property-based critique of the directors' duty statutes, see *infra* pt. IV(D)(1).

108. *See infra* pt. IV.

In order to assess the negative impact of the directors' duty statutes, it is necessary to understand how the new statutes alter shareholders' rights to challenge objectionable management decisions. Under traditional doctrine, management is subject to common law fiduciary duties of loyalty and care. The duty of loyalty mandates that a director "should not use his [or her] corporate position to make a personal profit or gain other personal advantage."[109] The idea is that, as fiduciaries, directors (and senior officers too) owe a duty of undivided loyalty to their principal, the corporation. Most of the legal doctrine in this area is concerned with various species of conflict of interest transactions.[110]

According to a typical formulation of the duty of care, a director should "perform his [or her] functions in good faith, in a manner that he [or she] reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[111] The duty covers both negligent failure to act and decisions taken without appropriate care, including decisions reached without sufficient information regarding the matter at issue. In addition, director action may be challenged on the ground that, from an objective standpoint, it could not rationally have been deemed to be in the corporation's best interests. Thus, for example, a decision that amounts to waste of corporate assets cannot be justified on the ground that it was disinterested and the result of a reasoned decision process.[112]

Shareholders have traditionally enjoyed the right to enforce the fiduciary duties of care and loyalty through litigation.[113] However, the practical significance of this right has always depended in large part on the so-called "business judgment rule," which insulates managerial decision-making from shareholder (and judicial) scrutiny. Thus, before it is possible to determine how the directors' duty statutes affect the common law duties of care and loyalty, it is first necessary to consider the business judgment rule in light of the new statutes.

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109. *Corporate Director's Guidebook*, *supra* note 18, at 1599.

110. *See generally* R. Clark, *supra* note 21, at 141-89.

111. ALI Principles, *supra* note 17, § 4.01(a).

112. In this respect, the duty of care can be said to require substantive as well as procedural due care. W. Cary & M. Eisenberg, Cases and Materials on Corporations 541 (6th ed. 1989).

113. In form, the challenge is usually by means of the shareholders' derivative action, in which particular shareholders sue on behalf of the corporation to obtain a remedy for past or threatened financial harm to the corporation. The typical case is one in which managerial negligence or self-dealing has resulted in a financial loss to the corporation. In contrast to derivative suits are direct actions, in which a shareholder (or a class of shareholders) asserts a claim based on an injury suffered by the shareholder as such. Examples include efforts to enforce voting rights or to compel payment of dividends. *See generally* R. Clark, *supra* note 21, at 639-74.

The business judgment rule has been expressed in different ways in different jurisdictions, but the basic idea is the same.[114] Courts will not allow shareholders to challenge exercises of managerial business judgment if, at the time of the decision, three prerequisites were satisfied. The decision in question must have been the product of (i) disinterested and (ii) informed judgment, and (iii) an objectively rational effort to further the corporation's best interests.[115] Accordingly, the business judgment rule requires a shareholder seeking to challenge a board decision to show that the directors were subject to a conflict of interest with respect to the matter at issue,[116] failed adequately to inform themselves prior to reaching the decision,[117] or, from an objective point of view, could not rationally have believed that the decision was in the corporation's best interests.[118] An allegation of irrationality requires a court to evaluate the substantive merits of the decision in question. Here, under traditional doctrine, the shareholder primacy principle comes into play. Absent some demonstration of likely long-term financial gain to the corporation, a decision to sacrifice profits solely to benefit employees or other non-shareholders would not enjoy the protection of the business judgment rule. Even if the directors were fully informed and had nothing to gain personally from the decision, it would fail the rationality test because of its inconsistency with shareholder financial interest.[119]

Only if the disgruntled shareholder can demonstrate that at least one of these three conditions (conflict of interest, inadequate information, irrationality) is present will he or she be allowed to proceed with a

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114. For extended analysis of the variations, see ALI PRINCIPLES, *supra* note 17, at 58-76 (comment and reporter's note to § 4.01(c)).

115. One area in which formulations of the business judgment rule differ is with respect to the rationality element. Some jurisdictions have used a reasonableness standard instead. *See* ALI PRINCIPLES, *supra* note 17, at 67-68. Some jurisdictions also add a requirement of good faith.

116. *See* R. CLARK, *supra* note 21, at 138.

117. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

118. *See, e.g.*, ALI PRINCIPLES, *supra* note 17, § 4.01(c)(3).

119. For example, in Shlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968), a shareholder sought to challenge a corporate policy (no lights at Wrigley Field) alleged to be inconsistent with profit maximization. According to the plaintiff, management was motivated by a conviction that baseball is a "daytime sport" and concerns that night baseball would lead to deterioration of the neighborhood surrounding the ballpark, rather than by "interest in the welfare of the corporation." The appellate court affirmed dismissal of the complaint not because such a policy was entitled to the protection of the business judgment rule but rather because the plaintiff had failed to allege adequately that management's motives "are contrary to the best interests of the corporation and its stockholders" and that the policy might not in fact be related to legitimate financial objectives. As a decision about proper pleading, the opinion is hyper-technical and thoroughly disingenuous.

lawsuit alleging management misconduct. Thus, the business judgment rule is designed to shield directors from judicial scrutiny if they acted properly at the time of the conduct at issue — even though their decision later proves harmful to the corporation.[120] In addition, because the shareholder bears the burden of proving that at least one of the prerequisites to business judgment rule protection was not satisfied, the business judgment rule also furnishes a presumption that directors act in a disinterested, informed, and rational manner when they make management decisions.[121] Only if a shareholder can overcome this presumption will he or she be able to challenge the merits of management's conduct. Thus, whether the business judgment rule blocks a particular shareholder claim and the merits of the claim itself are actually two distinct questions.

To appreciate the impact of the new statutes on shareholders' ability to challenge management decision-making, it is necessary first to consider how the statutes alter traditional business judgment rule analysis. There does not seem to be any change with respect to the requirement of disinterest. Although the new statutes allow management to deviate from relentless pursuit of profit maximization, they offer no basis for an argument that management's own self-interest is an acceptable justification for such deviations. Some statutes include a residual catch-all category among the listing of specified nonshareholder considerations that justify management's subordination of shareholder welfare (such as "other pertinent factors"[122]). However, even if this category were interpreted to extend beyond the listing of specific nonshareholder constituencies that appear to be the statutes' intended beneficiaries, there is no warrant for adding management's own interests to the list of legitimate considerations. The directors' duty statutes authorize management to use its discretion to protect nonshareholders at the expense of shareholders, but do not allow management to transfer corporate wealth to itself. So, a shareholder seeking to challenge a management decision still should be able to avoid the business judgment rule by arguing that the decision in question was tainted by conflict of interest.

In addition to cases of conflict of interest, it still should be possible to challenge a decision on the ground that management failed adequately to inform itself beforehand. For example, in cases of decisions that relinquish profit maximization out of solicitude for nonshareholders, a

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120. The reason for this is the belief that, on the one hand, managers are chosen for their business expertise and require a fair measure of discretion if they are to do their jobs effectively, while, on the other, courts are poorly qualified to second guess business decisions after the fact. *See Corporate Director's Guidebook*, *supra* note 18, at 1603-04.

121. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

122. *See, e.g.*, *supra* note 86 and accompanying text.

shareholder might claim that the board failed adequately to evaluate the respective costs and benefits to all affected constituencies (shareholders as well as nonshareholders) of the options before it. Absent such an evaluation, the business judgment rule's presumption of prudent, deliberate decision-making should not apply. Additionally, it might be argued that the board had no informed basis for believing, on the one hand, that a profit-maximizing option would harm identifiable nonshareholder constituencies and, on the other, that the decision actually taken would benefit those nonshareholders or at least avoid harming them. Thus, acting on inadequate information should remain a basis on which a shareholder seeking to challenge a management decision can overcome management's invocation of the business judgment rule.

Because they expressly authorize management to make decisions that take nonshareholder interests into account, the new statutes presumably have the effect of revising what counts as a rational decision under the business judgment rule. A decision that trades off shareholder gain against nonshareholder benefits may now be construed as rational. For example, the owners of a professional baseball franchise need not attempt to justify their refusal to install lights for night games on the ground that doing so will actually enhance the club's profitability by preventing deterioration of the surrounding community; they could simply rely on their desire to be good neighbors.[123] Iowa's statute attempts to address this issue expressly. After specifying the nonshareholder interests that a director may consider, the statute goes on to state the following:

> Consideration of any or all of the community interest factors is not a violation of the business judgment rule or of any duty of the director to the shareholders, or a group of shareholders, even if the director reasonably determines that a community interest factor or factors outweigh the financial or other benefits to the corporation or a shareholder or group of shareholders.[124]

Even in the absence of such language, however, the logic of the directors' duty statutes should preclude a shareholder from arguing against business

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123. *Cf. Shlensky*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (affirming dismissal of shareholder complaint because of failure to establish harmful financial impact of management's refusal to install lights to facilitate night baseball).

124. Iowa Code Ann. § 490.1108(2) (West Special Pamphlet 1990) (coverage restricted to "acquisition proposals"). Though the passage's meaning is clear, its reference to "violation of the business judgment rule" is an unfortunate malapropism. The business judgment rule is both an exemption from liability and a rebuttable presumption that directors exercise proper business judgment in making decisions. *See supra* notes 120-21 and accompanying text. It is not a substantive liability norm that can be violated. What the legislature meant was that consideration of nonshareholder interests does not provide a sufficient basis for denial of business judgment rule protection.

judgment rule protection simply on the ground that a management decision prefers nonshareholder over shareholder interests.

If this is so, under what circumstances might a shareholder argue against invocation of the business judgment rule on the ground that a particular decision was objectively irrational? Although it seems sensible to assume that the statutes are not designed to eliminate entirely the distinction between objectively rational and irrational managerial decision-making, the content of the distinction is no longer clear. An obvious example of objectively irrational behavior not entitled to business judgment rule protection would be a decision that, at the expense of the corporation's shareholders, conferred a benefit on some third party not legitimately entitled to management's largesse. An example might be a gratuitous cash payment to the surviving spouse of a recently deceased senior officer of the corporation. Another less obvious possibility might be a case in which management chose to forego a certain and very substantial benefit to shareholders in order to achieve a much more speculative and less substantial benefit for nonshareholders. The argument would not be that management acted irrationally by preferring nonshareholders over shareholders (the statute allows this), but rather that under the circumstances the balancing judgment was so sharply skewed against the shareholders and of so little benefit to nonshareholders as to be objectively irrational.

To sum up the analysis thus far, the directors' duty statutes alter the grounds available to shareholders for overcoming the business judgment rule's presumption in favor of management. Shareholders should retain the right to challenge management decisions tainted by self-interest. In cases of decisions that benefit nonshareholders at the shareholders' expense, shareholders should be able to argue in appropriate cases that such decisions were based on inadequate information, but should no longer be allowed to argue that any decision sacrificing profit maximization for the sake of nonshareholder interests is objectively irrational for that reason alone. In this respect, the new statutes significantly restrict shareholders' rights to hold management accountable.

If a complaining shareholder is able to overcome the business judgment rule's hurdle to judicial scrutiny of managerial decision-making, he or she must still prevail on the merits of the underlying claim. In this regard, the duties of care and loyalty should be much the same as under traditional doctrine.[125] One important difference must be noted,

125. As already noted, the duty of loyalty proscribes management decision-making on the basis of self-interest. *See supra* text accompanying notes 109-110. The new statutes authorize deviation from shareholder primacy only for the sake of specified nonshareholder

however. A management decision to sacrifice shareholder interests in order to benefit nonshareholders no longer amounts to a per se violation (such as waste of corporate assets).[126] For example, even a clearly stated management policy to use corporate revenues to improve wages and working conditions and to offer the company's product to the public at a lower than profit-maximizing price would not, without more, appear to be a basis for liability or injunction.[127] In this regard, several directors' duty statutes provide expressly that management shall be exempt from personal liability for decisions taken pursuant to the statutory authorization to consider nonshareholder interests.[128]

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interests; they do not allow managerial self-dealing.

The duty of care requires management to act "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." ALI Principles, *supra* note 17, § 4.01(a). This implies a requirement that management be adequately informed before deciding to protect nonshareholders at the shareholders' expense. Indiana's statute makes this clear: A disinterested decision, reached after consideration of nonshareholder interests, "shall conclusively be presumed to be valid *unless* it can be demonstrated that the determination was not made in good faith after reasonable investigation." Ind. Code Ann. § 23-1-35-1(g) (West Supp. 1990) (emphasis added). This relevant information should include evaluations of the likely costs and benefits of a particular decision to all affected constituencies, including shareholders and nonshareholders.

It should be apparent that the evidence bearing on liability in such cases (lack of adequate information) is the same as the evidence that a shareholder would cite in order to overcome the business judgment rule's presumption. This will not always be the case, however. For example, if the claim is conflict of interest, the plaintiff must first establish the existence of a legally sufficient conflict to rebut the business judgment rule's presumption and, if successful, will then have to litigate a different issue, the substantive fairness of the transaction at issue. *See, e.g.*, Del. Code Ann. tit. 8, § 144(a) (1989).

126. A disgruntled shareholder might try to characterize such a decision as a violation of the duty of loyalty (on the ground that management acts disloyally when it favors the interests of some particular constituency), but the duty of loyalty has traditionally been interpreted in terms of illegitimate managerial efforts to promote self-interest rather than the interests of third parties.

Alternatively, a plaintiff might attempt to frame such a challenge in terms of the duty of care, on the theory that the duty of care includes a substantive element recognizing that certain decisions (however prudent they may appear to be from a procedural point of view) are objectively irrational. *See supra* text accompanying note 118. However, the mere fact that management has chosen to prefer nonshareholder interests over those of shareholders would be insufficient to demonstrate irrationality because the statutes allow management to act in this way.

There may still be something left to the rationality requirement, but it is unclear how helpful it would be to shareholders who object to policies favoring nonshareholders. One possible example of irrationality might be a decision that sacrificed very substantial shareholder gains for trivial nonshareholder benefits.

127. *Cf.* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (ordering payment of dividend when management sought to retain earnings to pursue policies contrary to shareholder financial interests).

128. *See* Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990); Haw. Rev. Stat.

From the shareholders' viewpoint, the principal doctrinal effect of the directors' duty statutes is to deny them the right to hold management accountable for decisions that renounce their interest in profit maximization in order to protect nonshareholders. The fact that a management decision has that objective no longer provides a sufficient basis for overcoming the business judgment rule's presumption of propriety or for proving a substantive violation. By revising traditional doctrine in this way, the directors' duty statutes allow management to protect nonshareholder interests without fearing liability to shareholders for their decisions. The effect is to decenter shareholders by abrogating the traditional shareholder primacy principle. It should be stressed, however, that the changes discussed here are purely doctrinal. Whether they will be of any practical importance to shareholders depends on the extent to which management actually chooses to exercise its authority to disregard shareholder welfare. In other words, as long as management pursues shareholder welfare, the loss of a right to challenge deviations from that norm will be unimportant. Thus, the practical significance of the changes discussed in this section will depend on how management behaves. That, in turn, will depend on whether the new statutes are interpreted as imposing affirmative responsibility on management to protect nonshareholders, as discussed in the next section.

IV. The Rights of Nonshareholders

We have seen that, in their negative aspect, the directors' duty statutes sharply curtail shareholder opportunities to challenge management decisions that sacrifice their interests to those of nonshareholders.[129] Yet, because the statutes are mostly phrased in permissive rather than mandatory terms, the extent to which management will exercise its new powers — and therefore the extent to which shareholders will suffer and nonshareholders benefit — is unclear. To approach the question of whether the new statutes incorporate an affirmative agenda entitling nonshareholders to management's solicitude, it is necessary to determine the circumstances under which nonshareholders can hold management accountable for decisions nonshareholders deem harmful to their interests. The first part of this section addresses that question, suggesting two possible interpretations. One would leave nonshareholders entirely reliant on management's discretion, while the other would acknowledge some

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§ 415-35(b) (Supp. 1990); Idaho Code § 30-1602 (1989); Ind. Code Ann. § 23-1-35-1(d) (West Supp. 1990); Mass. Gen. Laws Ann. ch. 156B, § 65 (West Supp. 1990); N.M. Stat. Ann. § 53-11-35(D) (Supp. 1989); Or. Rev. Stat. § 60.357(5) (1989); Pa. Cons. Stat. Ann. § 511(b) (Purdon Supp. 1990).

129. *See supra* pt. III.

minimal rights with respect to management's consideration of nonshareholder interests.[130] It will then be suggested that either of these readings would likely be of slight value to nonshareholders.[131] Accordingly, if the directors' duty statutes are to be taken seriously, a stronger interpretation of nonshareholder rights is needed.[132] After presentation of such an interpretation, some objections to it will be addressed.[133]

A. Defining Management's Responsibility To Nonshareholders

1. No New Rights.—A superficially appealing answer to the question of nonshareholder rights under the new statutes is to deny that they provide anything. We might term this the "no new rights" interpretation. This answer stresses that virtually all statutes make consideration of nonshareholder interests optional but not mandatory. That being the case, nonshareholders gain nothing from these statutes beyond what directors choose to give. This interpretation appears to be all the more forceful when the statute expressly states that no single group's interests shall be deemed controlling by the board.[134]

If courts were to interpret the directors' duty statutes in this manner, the effect would be to expand management discretion substantially. Management would enjoy the freedom to decide whether shareholder or nonshareholder interests should receive priority in particular situations. Decisions to favor nonshareholders could not be challenged by shareholders;[135] and nonshareholders could not challenge management decisions designed to promote shareholder interests at substantial cost to affected nonshareholder constituencies. In other words, the manner in which management chose to exercise its broad powers would be largely immune from judicial review.

It would be a mistake to adopt the no new rights interpretation of the new statutes. Courts should be reluctant to read them in a manner

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130. *See infra* pt. IV(A).

131. *See infra* pt. IV(B).

132. *See infra* pt. IV(C).

133. *See infra* pt. IV(D).

134. *See supra* notes 95 & 96 and accompanying text. Even when consideration of nonshareholder interests is required by the directors' duty statute (*i.e.*, Connecticut), nothing is said about how shareholder and nonshareholder interests are to be weighed against each other. Accordingly, once the board has assessed the relevant nonshareholder interests, it apparently is free to accord them whatever weight (including none) it wishes. Here, at least, a nonshareholder could sue management for simply ignoring his or her interest in the decision in question. But determining the remedy might be problematic, because it would be difficult, if not impossible, to show that compliance with the duty to consider might have resulted in a different management decision. *Cf. infra* note 137.

135. At least not as long as they were disinterested, adequately informed, and rational. *See supra* pt. III.

that creates such expansive and unaccountable power, while at the same time denying any meaningful role for the judiciary in policing the manner in which that power is exercised. Furthermore, if the statutes are read as leaving nonshareholder protection entirely to management's discretion, a variety of incentives will discourage management from using its powers to protect nonshareholder interests, a point discussed more fully below. This interpretation would therefore result in the statutes having virtually no effect at all. If that is so, the no new rights interpretation would amount either to judicial nullification of the directors' duty statutes or to imputation to the legislatures of empty intentions. However, before considering these incentives and the need for a stronger interpretation of nonshareholder rights under the new statutes, it is first necessary to examine how the no new rights interpretation conflicts with basic notions of management's responsibility to act with due care and should be rejected for that reason alone.

2. Minimal Protection.—An alternative to the no new rights interpretation of the directors' duty statutes would recognize limited opportunities for nonshareholders to challenge management decision-making. This reading — a "minimal protection" interpretation — is based on the traditional requirement of managerial due care. We have seen that directors are now empowered to sacrifice (or at least temper) devotion to shareholder wealth maximization when they decide that other values so merit. Decisions about *how* to weigh shareholder financial interest against nonshareholder considerations may now qualify as proper exercises of business judgment. Even here, however, the usual requirement that management exercise due care — with its attendant requirement of adequate information — would seem to apply.[136]

At the very least, nonshareholders should be able to challenge a decision adversely affecting them on the ground that it was uninformed. In this context, nonshareholders might contend that the board failed accurately to assess the impact of the decision in question on an affected nonshareholder constituency. As a result, its decision to adopt a policy harmful to that constituency was not the product of careful, reasoned deliberation. In other words, the statutes should be interpreted to require management to give adequate consideration to possible adverse effects on particular nonshareholder constituencies before deciding on a course of action designed to benefit shareholders. This implies that management needs to be both aware of possible adverse effects and adequately informed about their likely magnitude. Only then will management be in a position to deliberate about the significance of these costs in relation to expected shareholder benefits. Thus, this interpretation would ac-

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136. *See supra* pt. III.

knowledge that management has the discretion to pursue profitable transactions despite harmful effects on nonshareholders, but would allow it to do so only after having assembled and considered relevant information about such effects.

This does not seem too much to ask. As a general matter, the law's willingness to delegate power to make substantive choices need not imply lack of concern for the manner in which choices are made. To the contrary, the very act of delegation ordinarily implies an expectation that the power conferred will be exercised with reasonable care. This principle is reflected in corporate law's traditional requirement that management exercise its discretion to manage the corporation on the basis of adequate information and with appropriate deliberation. Under the directors' duty statutes, these discretionary powers are enlarged to include an authorization to take into account harmful effects on nonshareholders. It seems only reasonable to continue to require management to exercise its powers of choice in light of adequate consideration of the relevant options. Thus, delegating to management the power to protect nonshareholder interests implies a duty to ascertain whether and to what extent those interests are likely to be affected by particular decisions.

If so, a nonshareholder's claim that a decision was not based on adequate information should be sufficient to avoid management immunity based on the business judgment rule, just as it would be if a shareholder were attempting to challenge a decision on the same ground. In addition, if proved, lack of due care ought to be grounds for relief in suits by nonshareholders and shareholders alike. This interpretation would therefore acknowledge management's discretionary powers to choose between shareholder and nonshareholder interests, requiring only that those powers be exercised with knowledge and circumspection.

If the analysis offered here is sound, the new statutes should at least be interpreted to confer certain limited rights on nonshareholders, allowing them to formulate challenges to harmful management decisions on the ground that management's decision was uninformed.[137] However,

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137. Even if this interpretation is accepted, there is a potentially vexing question of causation in such cases. When the claim is that management failed adequately to inform itself about effects on nonshareholders (or failed to consider nonshareholder interests at all), aggrieved nonshareholders would presumably have to show that, had management acted with adequate information, it would not have taken the objectionable decision. This may be extremely difficult to prove. Nevertheless, perhaps a court should not be too hesitant about granting prospective injunctive relief in appropriate cases. Such a judgment would amount to an order to reconsider the matter at issue, paying adequate attention to relevant nonshareholder interests, and would not involve personal liability for money damages. As such, it would be an endorsement of the value of the deliberative process,

the question still remains whether nonshareholders have standing to bring suit under the new statutes. The statutes themselves are silent on this question, but courts should not deny rights of action to nonshareholders. One obvious reason is the standard one for implying private rights of action under statutes that neither confer nor deny such rights. As the statutes' intended beneficiaries, nonshareholders ought to be able to enforce whatever rights they gain under them. This argument is all the more forceful in situations, like this one, in which there is no reason to expect public authorities (or others) to vindicate the beneficiaries' interests by suing on their behalf.

There is a further reason for allowing nonshareholders to bring suit. The apparent goal of the statutes is to encourage, or at least allow, managerial attention to nonshareholder interests in cases in which exclusive devotion to profit maximization would be harmful. Under the minimal protection interpretation, management would be permitted, but not required, to exercise this power. It is therefore especially important to minimize significant disincentives for management to do so.[138] From the nonshareholders' perspective, there is concern that management will fail adequately to consider nonshareholder as well as shareholder welfare. Shareholders will have an incentive to challenge decisions that sacrifice their interests for the sake of assertedly offsetting benefits to nonshareholders. Thus, if management chooses a course of action that sacrifices shareholder interests for the sake of nonshareholders, there is at least some likelihood that it will be sued by a disgruntled shareholder. However, if management chooses to promote shareholder welfare instead, and adversely affected nonshareholders have no right of action, there

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rather than an assertion that management would necessarily have reached a different conclusion under hypothetically altered circumstances. However, when the harmful effects of a decision have already occurred, it may be harder to make a compelling case for monetary relief. Perhaps it should be enough to say that, if the relatively mild prohibition on management decisions that harm nonshareholders inadvertently or carelessly is to mean anything, courts will need to avoid overly scrupulous insistence on proof of causation.

Two further grounds for relief should also be mentioned, though these may be relatively unimportant. First, nonshareholders should be able to challenge decisions to benefit shareholders that are tainted by management's self-interest, as, for example, if a majority of the board members owns substantial blocks of stock. Second, even if a decision to benefit shareholders at a cost to nonshareholders is disinterested and adequately informed, it should be possible to claim that the decision is objectively irrational. However, as in the case of shareholder suits, the rationality requirement is likely to be relevant only in a relatively small range of cases. One category might include decisions designed to benefit shareholders that will result only in slight gains even if things work out as hoped, but will produce substantial detriment to a particular class of nonshareholders. Another would be cases of waste, in which management confers a benefit on some person or group having no legitimate claim.

138. *See infra* pt. IV(B) for further discussion of related issues.

is little if any reason to fear litigation challenging adverse impact on nonshareholders. Surely shareholders would not be expected to sue management because a financially beneficial decision also happens to impose costs on nonshareholders. So, unless nonshareholders can assert their rights under the statutes, the threat of suits by shareholders may encourage management to disregard nonshareholder considerations, and choose the safer course of preferring shareholder wealth maximization over competing nonshareholder interests. Such a result would, of course, render the statutes meaningless as a device for protecting nonshareholders. Thus, the availability of a right of action for shareholders suggests a reason for a corresponding right for nonshareholders.[139]

Even with a right of action, the interpretation of nonshareholders' rights under the new statutes offered in this section is far from generous. It only establishes a right to relief in cases in which management either entirely ignored affected nonshareholder interests or chose to subordinate such interests to shareholder welfare without first having adequately informed itself of relevant costs and benefits. If management is disinterested and adequately informed prior to making a decision, there is virtually no basis on which nonshareholders might sue management for choosing to pursue shareholder interests despite significant costs to nonshareholders.[140] Thus, although this interpretation is more generous than the no new rights interpretation discussed above,[141] it is still quite minimal. Whether it is at all adequate to the statutes' apparent objective of protecting nonshareholder welfare is considered next.

B. Incentives

Of the two interpretations of the new statutes discussed in the previous section, the minimal protection interpretation would at least require informed, disinterested evaluation of the impact of particular decisions on nonshareholder constituencies. Assuming a right of action were available, nonshareholders would be entitled to challenge management decisions on grounds that the decisions are based on inadequate information, tainted by conflict of interest, or substantively irrational.

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139. In form, nonshareholder challenges of the type discussed above might be deemed direct actions (as opposed to derivative, *see supra* note 113), because the injury complained of is a harm to a particular nonshareholder constituency, rather than to the corporation as a whole. Alternatively, however, if a decision to protect a particular nonshareholder group is conceived of as an effort by management to discharge a duty owed to the corporation, the action could be characterized as derivative, even though the beneficiaries of a judgment are only a single nonshareholder constituency.

140. The sole exception would be those odd-ball cases in which management's decision could be construed to be substantively irrational. *See supra* note 126.

141. *See supra* pt. IV(A)(1).

This is a more generous interpretation than the no new rights reading, but it does not require that management protect nonshareholder interests under any defined circumstances. As long as management collects and digests the necessary information, it would be free to pursue profit maximization without regard to adverse effects on nonshareholders.

If protection is limited to that provided by either the no new rights or minimal protection interpretations, and even assuming that nonshareholders enjoy a right of action, the statutes will have little if any beneficial effects for nonshareholders. Instead, various incentives will encourage management to focus its energies on shareholder welfare, for the most part leaving its newly minted discretionary powers on the shelf.[142] This is so for several reasons.

First, as noted previously, the new statutes do not extend voting rights to nonshareholders. The power to elect the corporation's board of directors therefore remains in the hands of the shareholders. However weak this power may be (because of management's control over the proxy machinery[143]), voting rights still represent a potentially meaningful check on the way in which management exercises its powers. Especially as large institutional shareholders take on an increasingly vocal monitoring role, managers who wish to retain their jobs and avoid controversy must be wary of disappointing the corporation's shareholders. In contrast, there would be little reason to fear the nonshareholders, at least as long as management does its homework well enough to minimize the likelihood of a successful lawsuit. This means that in cases in which management must choose between promoting shareholder welfare at a cost to nonshareholders or protecting nonshareholders at the shareholders' expense, the existence of shareholder voting rights encourages management to prefer the former option.

Existing executive compensation schemes that discourage management from tempering a commitment to profit maximization are another disincentive to regard for nonshareholders. This is obvious when bonus payments are tied to profitability. In addition, if grants of stock or of stock options are an important part of the compensation package, management will have an incentive to maximize share values. The long-term security of executive pension plans may also be perceived to depend in part on the corporation's financial performance.

Besides the voting rights disparity and the character of existing executive compensation schemes, several market-based incentives constitute a third factor discouraging regard for nonshareholders. These in-

142. The argument is not that management will be more attentive to shareholder welfare if the new statutes are interpreted minimally than it would be if there were no statutes at all. Rather, it will not be any less so.

143. *See* M. Eisenberg, The Structure of the Corporation 97-136 (1976).

centives are based on management's interest in ensuring that the corporation compete effectively with the other firms in its markets. Failure to do so would result in declining market shares and, ultimately, bankruptcy. As with voting rights and executive compensation, management's financial welfare, job security, professional reputation, and self-esteem are at stake. Even if such considerations do not guarantee that management will do everything in its power to pursue profit maximization, they still generate systemic pressures that lead management away from costly policies beneficial to nonshareholders.

One such market-based incentive is the existence of product (or service) market competition. Competition from other sellers in the same market will encourage management to trim costs. This objective can translate into losses for nonshareholders. For example, in a case in which maintaining operations at an older facility constitutes a productively inefficient use of the corporation's assets, management will feel pressured to close the plant. Failure to do so may disadvantage the corporation *vis-a-vis* its competitors. Thus, the need to minimize production costs creates an incentive for management to pursue efficiency rather than nonshareholder welfare.

Competition among corporations for debt financing may also have that effect. To the extent that lenders perceive an uncertain commitment to profit maximization as a threat to the corporation's financial stability, borrowing costs should be higher. These will be out-of-pocket costs in the form of higher interest rates, and may therefore impair the corporation's ability to compete. Accordingly, there is an incentive to pursue strategies that will facilitate lower-cost borrowing.

Capital market pressures may also be relevant. Sub-optimal performance is likely to increase the cost of raising capital through sale of equity; investors in newly issued stock who are asked to settle for a lower rate of return can be expected to demand a larger quantity of stock in return for their capital contribution. The higher cost of such stock offerings is not an additional out-of-pocket expense affecting the corporation's ability to compete in the product market.[144] Nevertheless, the greater the amount of stock to be issued, the greater the likelihood that existing shareholders will object that the percentage share of the corporation's total equity to be held by the new investors is too great in relation to the amount of their capital contribution. The result may be lawsuits by existing shareholders or dissatisfaction registered at the annual meeting.[145] Thus, the fact that corporations must compete with

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144. Eisenberg, *supra* note 38, at 1500-01.

145. Nevertheless, the significance of the higher capital cost factor should not be overstated. Most publicly held corporations do not depend on public offerings of stock

each other to obtain equity financing may also encourage profit maximization, despite negative effects on nonshareholders.

Finally, it should be recalled that only some corporations are subject to the new directors' duty statutes. Some states — notably Delaware and California — have not enacted them; presumably shareholder primacy (however diluted) will continue to be the governing norm for firms incorporated in these states. Thus, management of a corporation subject to a directors' duty statute may have to compete against companies for which adoption of policies designed to favor nonshareholders would be illegal. This factor could therefore compound the significance of the various market forces discouraging deviation from profit maximization.[146]

All these reasons taken together suggest that there will be substantial incentives for management to pursue profit maximizing options even when it is aware of foreseeable, substantial negative effects on particular nonshareholder constituencies.[147] If the statutes are interpreted as requiring nothing more than disinterest, adequately informed decision-making, and rationality, they can be expected to be of little benefit to nonshareholders. Critics of the directors' duty statutes have focused on management's broad discretion to choose between shareholder and nonshareholder interests, apparently unconstrained by guidelines about how this discretion is to be exercised.[148] Under this view, managers wield unprecedented power not only over questions of business policy but over the question of corporate purpose itself. However, the analysis offered above suggests that these critics may have little to fear. If there is no

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to generate needed capital, relying on retained earnings instead. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613, 648 (1988).

146. This discussion raises the possibility that states adopting directors' duty statutes could put their domestic corporations at a competitive disadvantage (*vis-a-vis* firms incorporated in other states) if the statutes were interpreted as requiring management to take nonshareholder interests into account. If the disadvantage were severe enough, the result might be reincorporation in a state (such as Delaware) that lacks such a statute. Before that possibility is taken too seriously, however, one would want to see some empirical evidence that the detrimental effect of management's conduct is sufficient to make a difference in the corporation's competitive position. Even if there is a noticeable effect, there may be other considerations (taxes or convenience, for example) that militate against reincorporation.

147. One market factor that may be of relatively limited significance is the market for corporate control. Such a market encourages management to maximize returns on corporate assets in order to deter potential hostile acquirers. *See generally* Manne, *supra* note 45. However, the combination of judicial decisions and antitakeover legislation, discussed in Part I(B)(2) above, have sapped the takeover market of much of its vigor. Another cause has been the withering of the junk bond market on which the takeover market depended in large part.

148. *See* Hanks, *supra* note 8, at 24-25; ABA Report, *supra* note 8, at 2269.

legal requirement that management protect nonshareholders, it is unlikely that it will do so.

One response to this analysis is to point out that management's dedication to profit maximization depends on its perception that such a course of action is in its self-interest. There may be situations in which self-interest will dictate use of the statutory power to disregard shareholder welfare. In other words, the interests of management and nonshareholders may be aligned under certain circumstances, and the incentives ordinarily encouraging promotion of shareholder welfare may not apply. In those cases, even a weak interpretation of the statutes will be sufficient to protect nonshareholders.

This observation may be accurate in the relatively isolated situations in which promotion of shareholder interests threatens management's job security. The obvious example is the hostile takeover. When nonshareholder interests are also threatened, management can use its authority under the directors' duty statutes to take whatever defensive actions are needed. In such cases, the statutes may work in the nonshareholders' favor even if management's responsibility to them is wholly discretionary. However, even in the hostile takeover situation, management and shareholder interests may be aligned, as for example, if generous golden parachute provisions apply. In any event, hostile takeovers are increasingly rare and represent only one among the many possible situations in which nonshareholders may be adversely affected by pursuit of shareholder welfare. They are also unique in presenting the likelihood that management will lose its job. Most other situations involving a choice between shareholder and nonshareholder interests (plant closings unrelated to changes in control, for example) involve no such threat. Thus, the cases in which management and nonshareholder interests will coincide will be relatively rare, and are not nearly frequent enough to justify confidence that management will use its statutory powers to protect nonshareholders on more than an occasional basis.

Under either the no new rights or minimal protection interpretations, the directors' duty statutes do not present as serious a threat to shareholder primacy as their critics fear. From a doctrinal viewpoint, the statutes would prevent shareholders from challenging management decisions that sacrifice shareholder interests for the sake of nonshareholder welfare. However, it is likely that they will fail to benefit nonshareholders because management will be reluctant to exercise its powers on nonshareholders' behalf. If the statutes are interpreted to impose only minimal requirements on management, they will have only minimal effect. Therefore, the need is to decide whether to read the statutes in a manner that trivializes and effectively nullifies them or, instead, to try to understand them as meaningful legislative efforts to protect nonshareholders from the harmful side-effects of overly zealous commitment to profit maximization.

C. *Taking the Directors' Duty Statutes Seriously*

If the directors' duty statutes are to have any significant effect, they must impose requirements on management that extend beyond minimal requirements of disinterest, adequate knowledge, and rationality. As part of a larger effort by the states to protect vulnerable nonshareholders from the excesses of exclusive devotion to shareholder welfare, the directors' duty statutes should be read in light of their political context. An interpretation that in effect renders the statutes vacuous ignores the magnitude of the problem they address and vitiates the legislatures' attempt at a solution. It also leaves corporate management with greatly expanded discretionary power, without any likelihood of meaningful benefits to the statutes' intended beneficiaries. The statutes therefore need to be interpreted in a way that mandates protection for nonshareholder interests under defined circumstances.[149]

This section suggests three broad principles governing management's exercise of its powers under the new statutes. These principles apply both within and outside of the hostile takeover context and are based on an understanding of the context out of which the statutes emerged. Before outlining the principles, it is necessary to revisit a few key points about that context. As discussed above,[150] the immediate occasion for the directors' duty statutes was the hostile takeover explosion. Before then, management's duty to the corporation could be interpreted as a duty to the shareholders because the interests of shareholder and nonshareholder participants in the corporate enterprise were assumed to be largely congruent.[151] So long as management pursued long-term strategies, all participants stood to gain. Profits would flow from investment in research and development and gradual expansion and adjustment of production in response to market conditions. Management promoted the firm's interest by supervising employee, supplier, creditor, and customer

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149. Statutory language apparently disclaiming the right of any corporate constituency to insist that its interests receive priority should present no obstacle to such an interpretation. *See supra* text accompanying note 95 (quoting Indiana's statute); *see also* Pa. Cons. Stat. Ann. § 511(b) (Supp. 1990) (quoted *supra* note 96); *cf.* N.Y. Bus. Corp. Law § 717(b) (McKinney Supp. 1990). The purpose of this language is not to deny rights to nonshareholders, but rather to state explicitly that shareholders are no longer entitled to the primacy they enjoyed under traditional corporate law principles. The Indiana statute seems to make this clear. Immediately following the sentence denying priority, the statute addresses shareholders' rights to tender offer premiums, explaining in effect that Indiana law does not require directors to promote shareholder interests in hostile takeover situations. *See* Ind. Code Ann. § 23-1-35-1(f) (West Supp. 1990). Thus, it would be a mistake to read such provisions as precluding efforts to interpret management's obligations to nonshareholders in a meaningful manner.

150. *See supra* pt. I(B)(1).

151. *See supra* text accompanying notes 78-79.

relationships in ways that minimized unexpected, uncompensated disruption.

Hostile takeovers presented a highly visible and dramatic instance in which shareholder interests and those of the other participants in the corporate enterprise diverged. Target company shareholders possessed the power to decide unilaterally whether particular hostile bids would succeed by virtue of their power to decide whether to tender their stock to the bidder. They could and did wield this power without regard to how changes in management and in corporate policy might affect nonshareholders. As a result, shareholders' desires for immediate gains often brought immediate costs to nonshareholders. Despite the absence of express contractual commitments by the corporation, many of these nonshareholders had legitimate expectations of long-term relationships with the corporation, built on implicit understandings and reliance.[152] By allowing shareholders to sell the company to the highest bidder, tender offers interfered with target company management's ability to pursue longer-term strategies in accordance with nonshareholder expectations, even when these might be to the ultimate benefit of target shareholders as well. Takeovers therefore focused attention on the distinction between short-term shareholder gain and attendant nonshareholder losses, on the one hand, and, on the other, the possible longer-term benefits to both shareholders and nonshareholders of the continued independence of the corporation.

The new directors' duty statutes, as a part of the broader judicial and legislative response to the harmful effects of hostile takeovers,[153] should be read as an effort to deny shareholders the power to realize short-term profits at the expense of management's discretion to pursue longer-term strategies from which both shareholders and nonshareholders might benefit. Because most of these statutes apply beyond the hostile takeover context, it seems entirely reasonable to conclude that they seek a similar goal beyond that context. Accordingly, the first principle that should guide interpretation of the directors' duty statutes is this: Management should not seek or allow short-term shareholder gains if frustration of legitimate nonshareholder expectations will result.

For example, it would be presumptively improper for management to adopt a policy that would result in the swift, unexpected layoff of large numbers of workers or the closing of a plant in a community in which that facility is an important citizen, even if the immediate financial benefit to the corporation would be significant. (This decision would only be presumptively improper because it might be justified under certain

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152. *See supra* text accompanying notes 47-48.
153. *See supra* pt. I(B)(2).

circumstances by reference to the third principle, discussed below.) The first principle would also embrace situations in which management must intervene to prevent shareholder profit-taking from harming nonshareholders. The most salient example would be a threatened bust-up takeover that would result in a large premium for shareholders but a substantial disruption of existing nonshareholder relationships. In other words, this principle is an explicit rejection of the view that management's duty is to promote short-term shareholder financial interests when significant harm to nonshareholder constituencies would follow.

Although the first principle would interpret the statutes as empowering management to disregard short-term shareholder gains in order to avoid nonshareholder losses, there is no basis for interpreting the statutes as authorizing management to disregard the profit motive altogether. It would be surprising to read so radical a message into these terse enactments, and there is no need to do so. Accordingly, the second principle requires management to pursue profit-seeking strategies that aim to harmonize the shareholders' financial interest and nonshareholder interests in stable relationships with the corporation.

This objective implies that management should run the corporation with an eye toward a longer horizon. That suggests a policy of patient attention to profit maximization through gradual, prudent adjustment to market circumstances, rather than radical, disruptive reactions motivated by a desire to shore up current profits. Some statutes refer expressly to the relevance of "long-term" considerations to managerial decision-making.[154] The decline of a robust takeover market, together with the empowerment to block destructive bids that the directors' duty statutes themselves provide, should give management the freedom needed to pursue such strategies.

As long as management adheres to the first and second principles, sharp conflicts of interest between shareholders and nonshareholders may be relatively infrequent. Long-term strategies can be formulated that minimize disruption of nonshareholder relationships. However, there will be times when preservation of existing relationships appears to be either impossible or so costly as to threaten the well-being of the enterprise as a whole. Plants will have to be replaced; suppliers may prove unable to trade at competitive prices. Under such circumstances, management's duty to respect existing nonshareholder relationships implies a larger duty to promote the welfare of the enterprise as a whole; after all, if the corporation collapses, all fall with it. Accordingly, the statutes should not be read as entitling nonshareholders to permanent relationships with the corporation under all circumstances. However, in cases of conflict

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154. *See supra* text accompanying note 87 and statutes cited *supra* note 88.

between the interests of the enterprise in maintaining profitable operations and those of a particular nonshareholder constituency in continuing a valuable relationship, the latter need not be sacrificed with impunity. Keeping their context in mind, the directors' duty statutes clearly reveal a concern about abrupt, unfair disruption of relations between the corporation and vulnerable nonshareholder constituencies. Accordingly, a third principle seems appropriate: In managing the company in a manner that pays due regard to profit maximization over the long-term, management should honor the legitimate expectations of nonshareholder constituencies if abrogation of existing relationships is necessary to serve the larger interests of the corporate enterprise as a whole.

A duty to consider the interests of particular nonshareholder constituencies therefore does not mean that plants can never be closed or supplier relationships terminated. It does mean, however, that management should conduct such transitions in a manner that minimizes losses to the affected parties. Substantial advance notice would seem to be a basic entitlement. In the case of employees, job transfer and retraining opportunities may also be appropriate. If losses resulting from disruption of legitimate expectations cannot be avoided, the objective should be full compensation for losses resulting from breach of commitments implicitly undertaken by management. If computation of such awards proves to be too difficult, it may be desirable to spell out these rights ahead of time by contract as, for example, through adoption of so-called "tin parachute" severance payment provisions.[155]

The interpretive principles offered here are admittedly very general. Even those who are sympathetic may find them too vague to be helpful. Terms like "legitimate expectations" and distinctions like "long-term" versus "short-term" are notoriously manipulable. If this is all that can be made of the statutes, some will conclude that it is not enough. (And those who are implacably hostile to the entire enterprise will find another reason to object.) In its defense, this approach relies on necessarily loose normative guidelines and, in effect, invites courts to develop a new body of common law in this area. The virtue of the common law method has always been its adaptability to new information and changing circumstances. This seems all the more suitable in a situation that involves factually and conceptually difficult issues, troubling political questions, and a sharp break with traditional legal doctrine. Perhaps the meaning of the general principles sketched here is best worked out in the context of concrete cases.[156]

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155. Protection might also include successorship requirements binding subsequent acquirers. For discussion of the use of tin parachutes and successorship requirements in these contexts, see Note, *supra* note 8, at 1473-84.

156. For example, what counts as legitimate nonshareholder expectations entitled to

Surely a comparatively more cautious, less ambitious approach is preferable to an effort to specify a large number of detailed, narrow rules. It would be an act of foolish hubris to reject nearly a century of accumulated legal development and, simultaneously, offer what purports to be a fully articulated replacement. Whatever wisdom and clarity such a project might appear to offer would be largely illusory because it is sure to require adjustment and creative interpretation in light of future problems now only dimly perceived. In any event, the statutes themselves speak in such general terms that a more finely textured interpretation seems inappropriate.

The interpretation suggested above implies a new conception of management's responsibilities to shareholders and nonshareholders. One might ask whether under this interpretation the new statutes extend the fiduciary principle from the management-shareholder nexus to the relations between management, on the one hand, and all the various corporate constituencies (shareholder as well as nonshareholder), on the other.[157] The problem with this conceptualization is that it implies that management owes fiduciary obligations to a wide range of beneficiaries whose interests will inevitably conflict from time to time. Used in this manner, the fiduciary idea, with its implication of undivided loyalty, does not seem very helpful.

One alternative is to continue to think of the shareholders as the beneficiary of management's fiduciary obligation, but to appreciate that the obligation is hemmed in by statutory responsibilities to nonshare-

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protection is best decided on a case-by-case basis. Even if legitimate expectations are defined more precisely (such as those growing out of relied upon, implicit understandings of long-term employment, as evidenced by firm-specific investments made in anticipation of long-term returns), the justice of a nonshareholder group's claim will depend on the factual circumstances, including the nature and history of the relationship with the corporation, the extent and character of the nonshareholders' reliance, the reasonableness of their expectations under the circumstances, the amount of compensation, and other factors. The difficulty of such evaluations would not be eliminated by expressing legal principles in the language of economic theory. For example, to state management's responsibility as a requirement that significant policy decisions be Pareto efficient with respect to nonshareholders as well as shareholders (*i.e.*, no one should be made worse off) would simply raise a new set of interpretive difficulties. General economic concepts are no more determinate than ordinary legal ones.

157. For an extended argument in favor of recognition of a fiduciary duty owed by management to the corporation's employees, see O'Connor, *supra* note 48. Though the existence of the new directors' duty statutes is one element on which O'Connor draws in support of her position, her argument is not presented as an interpretation of these statutes. Rather, she advocates creation of a common law fiduciary duty analogous to the nonstatutory fiduciary obligations traditionally owed by management to shareholders. *See also* McDaniel, *Bondholders and Stockholders*, 13 J. Corp. L. 205 (1988) (advocating fiduciary protection of bondholders).

holders. After all, there have always been limits on the shareholders' right to demand that management promote their interests. Most obvious is the traditional requirement that management act within the bounds of the law.[158] In addition, fraudulent conveyance principles restrict management's freedom to benefit shareholders at the expense of creditors.[159] Interpreted in the manner suggested above, the directors' duty statutes simply supplement existing restrictions on over-zealous pursuit of shareholder primacy.

Perhaps, however, it is preferable to think about management's fiduciary obligation as a duty to the corporation as such, rather than to any particular constituency. The directors' duty statutes invite us to jettison the traditional conflation of management's duty to the corporation with a duty to the shareholders. Doctrinally this was never accurate; management is an agent of the reified corporate entity rather than of its shareholders. Nevertheless, the conflation was long acceptable because both descriptively and normatively, it didn't seem to make much difference. Corporate and shareholder interests were perceived to be congruent and generally unthreatening to the various nonshareholder constituencies. How we conceptualize the nature of the corporation may have limited practical significance in any large sense, but it can nevertheless help us to clarify our thinking about particular normative questions.[160] By formulating management's duty as a duty to the corporate enterprise, we emphasize that management's responsibility to look after nonshareholders arises in the context of a more general duty to further the success of the corporation as a whole, conceived as a complex network of shareholders and nonshareholders. This idea rests on a normative perspective that rejects the notion that corporations exist solely to serve as investment vehicles for shareholders. This is only one of their functions. They also play a vital role in our society as employers, customers, suppliers of goods and services, and valued members of local communities. By redefining management's responsibility as a duty to the corporate entity, comprising nonshareholders as well as shareholders, corporate law acknowledges this fact.

D. *Objections*

The stronger interpretation of the directors' duty statutes offered above defines limitations on management's discretion that are designed to require protection of nonshareholder interests under certain circum-

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158. *See, e.g.*, ALI Principles, *supra* note 17, § 2.01.

159. *See generally* R. Clark, *supra* note 21, at 40-52.

160. For discussion of the role of theories of the corporation in legal and political discourse, see Millon, *Theories of the Corporation*, *supra* note 22, at 240-51.

stances. This interpretation would confer enforceable rights on nonshareholders to challenge particular management decisions. Definition and enforceability are necessary to overcome the incentives that will discourage management from exercising its powers to protect nonshareholders. The result will be restriction on management's ability to pursue shareholder welfare through profit maximization. This fact suggests one objection to the stronger interpretation: its damaging impact on shareholder property rights. If interpreted in the manner suggested here, the statutes will also interfere with shareholders' ability to structure their relations with nonshareholders through private ordering. In that respect, the statutes threaten efficiency. Both these objections are considered below.

1. Shareholder Property Rights.—By restricting management's ability to pursue shareholder welfare, the strong interpretation would have an adverse effect on shareholder property rights. Ownership of a share of stock would no longer imply a right to have management exercise its stewardship of the corporation in order to maximize the share's value. Of course, the new statutes do not authorize managerial self-dealing, sloth, or other forms of deliberate or negligent injury to shareholder financial interest.[161] Nevertheless, under certain circumstances, management would be required to put shareholder interests to one side in order to protect the interests of nonshareholders.[162] Because shareholders would have to settle for less than optimal financial performance, stock in corporations subject to the new statutes would presumably be worth less than before.[163]

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161. *See supra* pt. III.

162. Because nonshareholders would realize corresponding benefits, the statutes have been characterized as authorizing transfers of wealth from shareholders to nonshareholders and have been criticized on that account. *See* Hanks, *supra* note 8, at 24 (referring to management's power to allocate "stockholders' wealth" to other groups). However, what counts as shareholders' wealth depends in part upon how the shareholders' entitlements are defined by corporate law. While the enactment of the statutes may be said to have a negative impact on shareholder wealth, management decisions pursuant to the statutes would not involve wealth transfers unless there was a pre-existing entitlement involved. However, the new statutes redefine the shareholders' status in a way that redefines their entitlements. Thus, it is inaccurate to characterize management's power in terms of the power to transfer wealth.

163. It is possible that the stock market would assign a relatively small negative value to the new statutes. The magnitude of the effect would depend in large part upon their practical effects. It may be that these will be only occasional; if management is still able effectively to pursue profit maximization most of the time, the impact on share values may be insubstantial. In any event, the extent to which stock prices respond to apparently significant changes in the law is not clear. *See* Weiss & White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 Calif. L. Rev. 551 (1987) (analyzing effect of seven important judicial decisions on stock prices and finding no significant correlation).

As a legal argument, this objection is weak. Legal transitions do not present serious legal difficulties simply because they cause incidental, uncompensated diminution of share values. Shareholders have always been on notice that states can change the law governing their corporations. Taking the lead from Justice Story's opinion in *Trustees of Dartmouth College v. Woodward*,[164] state general incorporation laws routinely include provisions reserving the right of amendment and announcing their potentially retroactive force.[165] It might even be said that shareholders tacitly consent to such changes in advance by buying stock under these circumstances.

Shareholders cannot fruitfully respond that the shareholder primacy principle is somehow embedded or inherent in the essence of corporate stock. State legislatures define the content of these property rights. By redefining them, the legislatures are simply exercising a prerogative that has always been theirs.[166] For example, the one-share, one-vote principle, which may seem so fundamental as to be timeless, was by no means a universal feature of nineteenth-century corporate law.[167] So too, it has not been long since state legislatures eliminated the individual shareholder's veto power over fundamental corporate changes by doing away with the requirement of unanimous shareholder approval.[168] In short, there is no "ideal type" that defines the transcendental essence of stock.

One can respond that, however legally justified the state's redefinition of stock ownership rights might be, the change would be bad policy. Investors will find stock in corporations subject to the new directors' duty statutes less attractive relative to other investment opportunities, including stock in corporations not subject to the statutes. As a result, it will be more costly for some companies to raise needed capital, and potentially disastrous economic consequences will follow.[169] It might even come to pass that the very nonshareholders the state legislatures seek to protect will find themselves victims of bankruptcies and resultant plant closings.

Why might it make sense to interpret the statutes in a way that could lead to such results? For one thing, the empirical validity of these claims is unknown; the dire consequences may be overstated.[170] Even if

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164. 4 Wheat. 518 (1819).

165. *See, e.g.*, Del. Code Ann. tit. 8, § 394 (1989).

166. *See generally* Johnson, *supra* note 107.

167. *See* E. Dodd, American Business Corporations Until 1860 with Special References to Massachussets 326 (1954).

168. *See* Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, in Corporations and Society: Power and Responsibility 13, 35-37 (W. Samuels & A. Miller eds. 1987).

169. *See* Hanks, *supra* note 8, at 25.

170. *See supra* note 163.

the effect on share prices were significant, however, offsetting considerations might justify it. Courts and state legislatures first placed new obstacles in the way of alienability (restricting shareholder opportunities in the hostile takeover context) in response to public policy concerns about the adverse effects of takeovers on nonshareholders. Then, in the directors' duty statutes, the states have taken the potentially much bolder step of effecting a general redefinition of management's responsibilities. The justification for statutes that are likely to impose costs on shareholders (and perhaps some nonshareholders too) is the political judgment that the intended benefits to nonshareholders are worth that price.

The manner in which shareholder property rights are defined is a manifestation of the states' general power to specify the content of property rights in order to promote justice or utility. So-called private property rights always exist in order to give expression to public values; the survival of a given property law regime depends ultimately on its social utility.[171] Once a particular legal doctrine is thought of as obsolete, it can and will be replaced with a new one. The directors' duty statutes are an example of this process at work.

2. *Efficiency*.—An interpretation of the directors' duty statutes that qualifies management's responsibility to maximize profits could also be criticized on efficiency grounds.[172] Instead of a firm structured as a network of bargained-for relationships among shareholders (acting through management) and nonshareholders, management would find itself obliged to make decisions that are designed to benefit nonshareholders at the shareholders' expense. To the extent that management acts in this way, one result may be less productive utilization of corporate assets. Corporations would be less efficient in the sense that fewer goods and services would be produced than would have been had management pursued profit maximization without regard to nonshareholder considerations. According to the proponents of economic efficiency, society as a whole will suffer if assets are not put to optimally productive uses.

From this perspective, the directors' duty statutes impede efficiency because the manner in which corporate assets are deployed and wealth is shared among the participants in the corporate enterprise would cease to be determined through private ordering according to economic self-

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171. The legal realists made this point forcefully. *See* Cohen, *Property and Sovereignty*, 13 CORNELL L.Q. 8 (1927); Hale, *Bargaining, Duress, and Economic Liberty*, 43 COLUM. L. REV. 603 (1943). For a more recent analysis of this and related aspects of legal realism, see Singer, *Legal Realism Now*, 76 CALIF. L. REV. 465 (1988).

172. *See* ABA Report, *supra* note 8, at 2268 (deviation from corporate law's traditional commitment to shareholder primacy "could undermine the effectiveness of the system that has made the corporation an efficient device for creation of jobs and wealth").

interest.[173] Nonshareholders would no longer be left to their own devices to identify and protect their interests through the bargaining process, while shareholders would lose the right to insist on profit maximizing strategies. Management interventions on behalf of nonshareholders are therefore likely to leave shareholders worse off than they would have been under the traditional corporate law regime. Additionally, nonshareholders might find themselves parties to relationships with the corporation that they themselves would have chosen to structure differently. For example, instead of protection through the directors' duty statutes, some employees might prefer that management relentlessly pursue corporate profit maximization as long as they receive higher wages and contractually tailored job security provisions in return. Thus, the new statutes might result in wealth sharing arrangements that nonshareholders as well as shareholders regard as less than optimal.

It is possible to take the efficiency critique a step further. In place of a regime based on private ordering, the new statutes would establish an "oligarchy" in which corporate management decides how resources will be allocated and corporate wealth distributed within the relatively loose constraints of the directors' duty statutes.[174] "Public" or "political" questions of wealth distribution would thus be committed to the discretion of private individuals rather than the impersonal workings of the market.[175]

While the strong interpretation of the directors' duty statutes would redefine the parties' ability to use private ordering to structure their relationships, that fact alone does not render the interpretation indefensible. It can be justified on grounds that reject the basic premises on which the efficiency critique rests. As interpreted here, the directors' duty statutes reflect a deep distrust of the efficiency model's bargain paradigm. According to this perspective, private ordering is an inequitable process for structuring relationships between parties of unequal wealth and information. These disparities can generate significant bargaining disadvantages, and substantially impede the ability of the less powerful to protect their interests adequately through contract. Where the con-

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173. Note that this criticism implies that, but for the directors' duty statutes, corporate relationships are a product of private ordering. In fact, of course, private ordering takes place within an environment that includes many mandatory legal elements. One might say that, even if the directors' duty statutes are interpreted as suggested here, private ordering will still predominate. The rules of the game will be different, and therefore outcomes will be too, but it is incorrect to contrast a state of pure bargain with a state of pure regulation. At most, these are questions of more or less.

174. *See* Cox, *supra* note 12, at 209-12.

175. *See* ABA Report, *supra* note 8, at 2270.

servative economist sees voluntariness, bargaining, and wealth-increasing exchange, the critic sees coercion and severely limited choice.[176]

Seen in this light, a commitment to private ordering in the context of corporate law is itself "oligarchical."[177] Rather than an impersonal mechanism for wealth allocation through individual activity (to be contrasted with the arbitrary private power of corporate management), the market represents an opportunity for shareholders to impose their will on workers and others who lack the ability to protect themselves fully through contract. These nonshareholders find themselves dependent on management's good will for their well-being, but management must respond to the wholly self-interested hunger for short-term profits that drives an increasingly small number of arbitrageurs and institutional investors.[178] Under these circumstances, nonshareholders' inability to obtain fully specified contractual protection leaves them victim to opportunistic disregard of their interests. Market decision-making is thus no less oligarchical than the regime that would be inaugurated by the strong interpretation of the directors' duty statutes. The difference is in who will decide and, more importantly, in whose interest.

Distrust of the fairness of private ordering as a process is not the only reason for rejection of the efficiency norm. Commitment to efficiency as the central value in a normative system presupposes the justice of the existing distribution of wealth. If one views that distribution as unfair, individual pursuit of wealth maximization through bargaining will not correct the unfairness, however fair one might consider the bargaining process to be. Instead, existing disparities are likely to be replicated and perhaps intensified through the market.[179] This perspective on efficiency as a normative criterion therefore provides a further justification for legal intervention.[180]

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176. *See supra* note 171 and sources cited therein.

177. *Cf. supra* text accompanying note 174.

178. *See* Lipton, *supra* note 73, at 7-9.

179. *See* J. Coleman, Markets, Morals and the Law 319-20 (1988).

180. Though I prefer to read the statutes as a rejection of the efficiency norm and its premises, it is still possible to construct a defense of the new statutes on efficiency grounds. One might view the statutes as grounded on a belief that the traditional shareholder-management relationship, with its requirement that management maximize shareholder wealth, imposes significant externalities on identifiable nonshareholder constituencies. These nonshareholders are unable to protect themselves adequately through contract because transaction costs, such as severe informational disparities, stand in the way of effective contracting strategies. For example, the traditional legal duty to maximize shareholder interests threatens to cause lost jobs, disruption of other valuable economic relationships, and imposition of costs (such as unemployment benefits) on the general public. However, because employees often lack access to information about the likelihood of future layoffs and other plans to improve productive efficiency, employees are unable to insist on contract

The difference between this justification for nonshareholder protection and the views of the efficiency proponents is thus quite a bit wider than a disagreement about how to apply economic analysis to corporate law. A strong interpretation of the directors' duty statutes would reflect a rejection of basic positive and normative premises of neoclassical economic orthodoxy. It would reflect a willingness to interfere with efficiency in order to promote a program that restructures the power relationships within the corporation. Corporate law has always shaped those relationships. The new structure proposed here would redistribute power (and therefore wealth) from shareholders to nonshareholders through the mechanism of managerial supervision of the relations among shareholders and nonshareholders. If that is to be the statutes' meaning, it makes little sense for conservatives to criticize them on efficiency grounds. They should instead focus their efforts on the much more difficult task of persuading the public that theirs is a normative vision worthy of broad appeal.

Conclusion: Toward A New Definition Of Corporate Law

It is not enough simply to analyze the new statutes' negative doctrinal implications for the shareholder primacy principle. Even if shareholders lose the right to insist that management privilege their interests, it is by no means clear that management will use its statutory powers to protect nonshareholders at the expense of shareholders. Unless the statutes are interpreted as imposing affirmative obligations on management, there are good reasons to believe that nonshareholders will derive little benefit. So, if the directors' duty statutes are to have any significant meaning, it is necessary to make something constructive out of them. That has been the principal focus of this Essay.

The directors' duty statutes are not intended to provide a blueprint for a new vision of the corporation. Their thrust is as yet largely negative: The states wish to curb existing management tendencies to prefer the

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terms that are well-tailored to their interests. Difficulties may be even greater in situations in which actors (such as local governments) make firm-specific investments in the expectation of a long-term corporate presence but are not in contractual privity with the corporation. Accordingly, statutory protection may be necessary in order to give nonshareholders the rights they would have bargained for in the absence of transaction costs. However, as a justification for the strong interpretation of the new statutes, the suggestion that it aims to mimic the outcomes of private ordering is probably of limited utility. For one thing, the statutes themselves offer no obvious suggestion that they are designed to correct market failure. Further, defenders of protection for nonshareholders would probably make a serious strategic mistake if they limited themselves to defending intervention solely on grounds of efficiency. It probably makes more descriptive and strategic sense to interpret the new statutes as rejecting, for political reasons, the efficiency perspective.

short-term financial interests of shareholders despite the often substantial costs to nonshareholders. In so doing, they reject the orthodox shareholder primacy principle. Yet this negative aspect inevitably implies an affirmative one. By decentering the shareholder, the statutes also reject corporate law's traditional fixation with the shareholder-manager relationship and thrust nonshareholders into the limelight as legitimate objects for corporate law's attention. This in turn seems to be based on a conception of corporate purpose that is much more complex than profit maximization and shareholder welfare. Although these changes imply a fundamental reorientation of corporate law, the statutes speak tentatively and the contours of the new order are as yet uncertain.

It is conceivable that the directors' duty statutes herald the beginnings of a radically different understanding of corporate law and corporate purpose. If they are manifestations of a deeper design to enhance the status of nonshareholders within the corporate enterprise, several lines of development are possible. One could imagine greater nonshareholder involvement in the decision-making process, through voting rights, for example. More radically, we might revise our notion of corporate governance so as to replace the present hierarchical structure with one in which significant decision-making authority spreads downwards, from management into the hands of those most directly affected. And if nonshareholders are to have powers of control, perhaps new ownership structures should be considered as well.

The directors' duty statutes will not provide the vehicle for such developments. Nevertheless, these statutes raise fundamental normative questions about the appropriate aims of corporate law and about corporate purpose itself. In defining management's responsibilities to shareholders and nonshareholders, courts will face choices. As we have seen, it is possible to interpret the directors' duty statutes in ways that effectively trivialize them. To do so would be a mistaken attempt to shore up a crumbling status quo that no longer rests on a firm foundation of societal consensus. Alternatively, the courts can participate in the dialogic process — involving concerned citizens, legislators, and academics, as well as judges — by which society redefines corporate law and the meaning of the corporation itself. The directors' duty statutes challenge the courts to engage in this conversation. Whether these statutes prove to be as revolutionary as their critics suggest will depend on what we make of them.

Indemnification of Corporate Executives Who Have Been Convicted of Crimes: An Assessment and Proposal

Pamela H. Bucy*

Payments to indemnify corporate executives[1] convicted of crimes, though ostensibly forbidden by state incorporation codes and Directors and Officers (D&O) Liability Insurance policies,[2] can actually occur routinely, and quietly. This system of corporate indemnification is both excessive and overly restrictive — excessive because corporations' ability to fully indemnify executives convicted of criminal offenses is potentially unlimited, yet overly restrictive because executives who perform in good faith and are virtually vindicated by criminal proceedings[3] have no

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1. In this Article, the term "corporate executives" refers to directors, officers, employees, and agents unless otherwise noted. Some incorporation statutes distinguish between these positions when discussing indemnification. *See, e.g.*, Revised Model Business Corp. Act, §§ 8.50-8.58 (1984) [hereinafter RMBCA]. A greater number do not. *See, e.g.*, Del. Code Ann. tit. 8, § 145 (1983 & Supp. 1988). Generally, Directors and Officers (D&O) liability insurance policies treat directors and officers equally. *See, e.g.*, Stewart Smith D&O Insurance Form, in J. Bishop, Law of Corporate Officers and Directors, Indemnification and Insurance (1981 with annual supplements) at ¶ 8.04 (1990) [hereinafter Indemnification and Insurance].

2. State incorporation codes give corporations the power to indemnify for costs arising from "civil, criminal, administrative or investigative" matters but indemnification for criminal matters is permitted only if the executive meets certain conditions, including having "no reasonable cause to believe his conduct was unlawful." *See, e.g.*, Del. Code Ann. tit. 8, § 145(a) (1983 & Supp. 1988). Intuitively, it would appear that a person convicted of unlawful behavior would not meet this condition, and therefore, that the indemnification statute forbids indemnification to a convicted executive.

D&O insurance policies specifically exclude from coverage "fines or penalties . . . charges or expenses of grand jury or criminal proceedings" and claims "arising from, brought about or contributed to by the dishonest, fraudulent or criminal acts of any [executive]." P. Richter, Indemnification of Directors and Officers app. at 2-6 and 2-8 (Securities Law Series 1989-1990) (reprinting sample D&O policies).

At common law reimbursement to convicted executives was disallowed. See *infra* notes 158-97 and accompanying text for a discussion of this common law and its development.

3. "Virtually vindicated by criminal proceedings" refers to the situation where a defendant is acquitted, or secures a dismissal, of all of the serious charges filed against him but is convicted on a single, or few, minor offenses. *See infra* notes 36-53 and accompanying text.

statutory right to reimbursement. This odd result exists, in part, because indemnification developed in the context of civil liability[4] and was extended to the criminal arena simply by tacking a few words about criminal liability onto existing indemnification statutes.[5] Unfortunately, this extension was unaccompanied by a thorough analysis of the practicalities and unique policy concerns of the criminal law.[6]

If convicted, it is likely that corporate executives will be assessed fines and penalties. They will undoubtedly incur attorneys fees for their unsuccessful defense. If acquitted or if the charges are dismissed, the executive will not be assessed fines or penalties but will have incurred attorneys fees. Currently, there are two major avenues through which corporate executives may seek reimbursement for these costs. The first is from the corporation, which receives power to indemnify its executives from state incorporation statutes or from internal sources such as bylaws or contracts. The second avenue is the D&O insurer. Executives turn to a D&O insurer when their corporation is either unwilling to indemnify, as in the case of a hostile take-over, or is unable to indemnify, as in the case of insolvency.

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4. Schwarz v. General Airline & Film Corp., 305 N.Y. 395, 113 N.E.2d 533, 535 (1953) (discussing historical development of New York's indemnification statute); *Note, Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, 76 HARV. L. REV. 1403 (1963) [hereinafter *Indemnification of Directors*] ("State indemnification law has largely developed in the context of shareholders' derivative actions . . . ."); *id.* at 1405 (discussing how the "breach of duty" standard in indemnification statutes has no applicability to third party (including criminal) actions).

5. In 1953 the New York Court of Appeals held that the New York indemnification statute, as passed in 1945, did not apply to criminal actions, despite the statutory language indicating that corporations were empowered to indemnify for costs arising from "any action, suit, or proceeding." *Schwarz*, 305 N.Y. at 403, 113 N.E.2d at 535-36 (interpreting 1945 N.Y. LAWS ch. 869). Thereafter in 1961, the New York legislature passed section 723 of chapter 855, which explicitly empowered corporations to indemnify directors and officers in any "action or proceeding . . . whether civil or criminal." 1961 N.Y. LAWS ch. 855, § 723.

It was not until 1968 that the Delaware statute was amended to cover criminal actions. It did so merely by adding the following language to the existing standards for permissive indemnification: "[W]ith respect to any criminal action or proceeding, [the executive seeking indemnification] had no reasonable cause to believe his conduct was unlawful." DEL. CODE ANN. tit. 8, § 145(a) (1968).

See, e.g., Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1407 (discussing this development in the Model Business Corporation Act); Note, *Indemnifying Corporate Officials for Williams Act Violations*, 50 IND. L.J. 826, 827-833 (1975) (discussing the historical development of indemnification).

6. Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitations and Indemnification*, 43 BUS. LAW 1207, 1231-1234 (1988) [hereinafter *Evaluating Recent Legislation*]; Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1408.

Part One of this Article addresses the first avenue and surveys the full panoply of opportunities corporations have to willingly, even eagerly,[7] indemnify corporate executives who have been convicted of crimes. This survey also covers the few odd occasions when deserving executives have no rights to indemnification. Part Two describes the additional reimbursement opportunities presented by D&O insurance which, as noted, is an executive's surrogate for indemnification when the corporation is unwilling or unable to indemnify. Part Three provides a summary and assessment of indemnification and D&O insurance, suggesting that our current approach poorly serves the public interest.[8] Appendix A contains a proposed indemnification statute that better accommodates the public

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7. The Fruehauf Corporation, a truck manufacturer in Detroit with $2 billion in annual sales, provides an apt example. In 1975, Fruehauf, its President and CEO, Robert D. Rowan, and its Chairman of the Board, William E. Grace, were convicted on a federal felony charge of conspiracy to evade more than $12.3 million in corporate federal excise taxes. Nathan, *Coddled Criminals*, HARPER'S 30 (Jan. 1980). Fruehauf not only kept Rowan on the payroll (at an annual salary of $500,000) during the trial and three years of appeals, but paid all legal fees the men incurred during the trial and the appeals. When a Fruehauf shareholder filed suit to recover the legal fees paid to Rowan and Grace, the Board of Directors fought the shareholder *after* passing resolutions indemnifying themselves for legal expenses they might incur fighting the shareholder. *Id.* at 31.

For other examples of corporations "eagerly" indemnifying their executives, see Koster v. Warren, 176 F. Supp. 459, 460 (N.D. Cal. 1959), *aff'd*, 297 F.2d 418 (9th Cir. 1961) (corporation paid $75,000 fine assessed against its former President after his plea of nolo contendere to criminal antitrust charges); Simon v. Socony - Vacuum Oil Co., Inc., 38 N.Y.2d 270, 274-275 (N.Y. Sup. Ct. 1942), *aff'd*, 267 A.D. 890, 47 N.Y.S.2d 589 (N.Y. App. Div. 1944) (corporation paid defense costs and fines assessed against directors after directors pled nolo contendere to criminal antitrust charges).

8. Scholars who have addressed the policy concerns raised by corporate indemnification and D&O insurance for both civil and criminal liability include: Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 BUS. LAW at 1207; Oesterle, *Limits on a Corporation's Protection of Its Directors and Officers From Personal Liability*, 1983 WIS. L. REV. 513 (1983) [hereinafter *Personal Liability Protection]*; Pillai & Tractenberg, *Corporate Indemnification of Directors and Officers: Time for a Reappraisal*, 15 U. MICH. J.L. REF. 101 (1981); Coffee, *"No Soul to Damn, No Body to Kick": An Unscandalized Inquiry Into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386 (1981) [hereinafter *No Soul to Damn*]; Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 (1980) [hereinafter *Enterprise Liability*]; Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW 1993 (1978) [hereinafter *Indemnification and Insurance*]; Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968) [hereinafter *Sitting Ducks and Decoy Ducks*]; Note, *Practical Aspects of Directors and Officers Liability Insurance - Allocating and Advancing Legal Fees and the Duty to Defend*, 32 UCLA L. REV. 690 (1985) [hereinafter *Practical Aspects of D&O Insurance*]; Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716 (1967); Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648 (1967) [hereinafter *Insurance for Executives*]; Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. 1403.

interest while also preserving the important, and needed, protection indemnification should provide.

I. Indemnification By the Corporation

A. Overview

Corporations are empowered to indemnify their directors and officers through four possible sources: statutes in force in the jurisdiction of incorporation,[9] bylaws, corporate resolutions, or contracts negotiated with individual directors.[10]

As part of its incorporation statute, each state has enacted provisions dealing with indemnification of corporate executives for costs associated with their corporate duties.[11] Currently, the most influential statutes are

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9. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 6.03[5]. *See, e.g.,* Wisener v. Air Exp. Intern. Corp., 583 F.2d 579, 581 (2d Cir. 1978); B. & B. Investment Club v. Kleinert's Inc., 472 F. Supp. 787, 789 (E.D. Pa. 1979); Gross v. Texas Plastics, Inc., 344 F. Supp. 564, 565-66 (D.N.J. 1972).

10. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶¶ 6.02, 7.01, 7.05 (Supp. 1985 & 1988); *cf.* Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 Wis. L. Rev. at 553-555 (discussing how waiver by a corporation of judgments awarded to it against an executive is another way of effectively indemnifying executives).

11. Ala. Code § 10-2A-21 (1987); Alaska Stat. § 10.06.490 (1989); Ariz. Rev. Stat. Ann. § 10-005 (1990); Ark. Stat. Ann. § 4-26-814 (1987); Cal. Corp. Code § 317 (West 1977 & Supp. 1990); Colo. Rev. Stat. § 7-3-101.5 (1990); Conn. Gen. Stat. Ann. § 33-320a (West 1987); Del. Code Ann. tit. 8, § 145 (1983 & Supp. 1988); Fla. Stat. Ann. § 607.014 (West 1986 & Supp. 1989); Ga. Code Ann. §§ 14-2-850 to -859 (1989); Haw. Rev. Stat. § 415-5 (1985 & Supp. 1989); Idaho Code § 30-1-5 (1980 & Supp. 1989); Ill. Ann. Stat. ch. 32, para. 8.75 (Smith-Hurd 1985 & Supp. 1990); Ind. Code Ann. §§ 23-1-37-1 to -15 (West 1989); Iowa Code Ann. § 496 A.4A (West Supp. 1990); Kan. Stat. Ann. § 17-6305 (1988); Ky. Rev. Stat. Ann. §§ 271 B.8-500 to -580 (Michie/Bobbs - Merrill 1989); La. Rev. Stat. Ann. § 12.83 (West 1969 & Supp. 1990); Me. Rev. Stat. Ann. tit. 13A, § 719 (1981 & Supp. 1989); Md. Corps & Ass'ns Code Ann. § 2-418 (1985 & Supp. 1989); Mass. Gen. Laws Ann. ch. 156B, § 67 (West 1970 & Supp. 1990); Mich. Comp. Laws Ann. § 450-1561 (West 1990); Minn. Stat. Ann. § 302 A.521. (West 1985 & Supp. 1990); Miss. Code Ann. §§ 79-4-8.50 to -8.58 (1972 & Supp. 1988); Mo. Ann. Stat. § 351.355 (Vernon 1966 & Supp. 1990); Mont. Code Ann. § 35-1-414 (1989); Neb. Rev. Stat. § 21-2004(15) (1987); Nev. Rev. Stat. Ann. § 78.751 (Michie 1987); N.H. Rev. Stat. Ann. § 293-A:5 (1987); N.J. Stat. Ann. § 14A:3-5 (West 1969 & Supp. 1990); N.M. Stat. Ann. § 53-11-4.1 (1983 & Supp. 1989); N.Y. Bus. Corp. Law §§ 721-727 (McKinney 1986 & Supp. 1990); N.C. Gen. Stat. §§ 55.8-50 to .8-58 (1990); N.D. Cent. Code § 10-19.1-91 (1985); Ohio Rev. Code Ann. § 1701.13(e) (Baldwin 1986 & Supp. 1990); Okla. Stat. Ann. tit. 18, § 1031 (West 1986 & Supp. 1990); Or. Rev. Stat. §§ 60.387 to .414 (1988); 15 Pa. Cons. Stat. Ann. § 1741 to 1750 (Purdon 1990); R.I. Gen. Laws § 7-1.1-1-4.1 (1985 & Supp. 1989); S.C. Code Ann. §§ 33-8-500 to -580 (Law. Co-op. 1990); S.D. Codified Laws Ann. §§ 47-2-58 to -58.7 (1983 & Supp. 1990); Tenn. Code Ann. §§ 48-18-501 to -509 (1988 & Supp. 1989); Texas Bus. Corp.

the Delaware statute[12] and the 1984 Revised Model Business Corporation Act (RMBCA).[13]

The first indemnification statute was passed by New York in 1941[14] in response to *New York Dock Co., Inc. v. McCollom*,[15] decided two years earlier. In *New York Dock*, the New York court of appeals held that a corporation did not have the power to pay the expenses of directors sued in a derivative suit who had successfully defended themselves on the merits.[16] This decision was contrary to the generally accepted common law view that corporations had power to reimburse successful executives.[17] Alarmed over this decision, business interests quickly rallied state legislatures to pass statutes empowering corporations to indemnify executives who incurred legal liability in the exercise of their corporate duties.[18] As new generations of indemnification statutes developed, more sophisticated features were added such as mandatory indemnification for the successful executive; indemnification for costs incurred in ERISA, criminal, administrative, and legislative actions; indemnification for threatened actions that never culminated in actual "claims" but which may have generated attorney fees; and, indemnification for costs incurred in compromise settlements.[19]

Since the mid-1980s, the trend in the states has been to statutorily expand the power of corporations to indemnify their executives.[20] Whereas the most dramatic expansion has been with regard to shareholder derivative lawsuits,[21] the expansion of exclusivity[22] and advancement of

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Act Ann. art. 2.02-1 (Vernon 1980 & Supp. 1990); Utah Code Ann. § 16-10-4 (1987 & Supp. 1990); Vt. Stat. Ann. tit. 11, § 1852(15) (1984); Va. Code Ann. §§ 13.1-696 to -704 (1989); Wash. Rev. Code Ann. § 23A.08.025, 23B.08.500 (Supp. 1990); W. Va. Code § 31-1-9 (1988); Wis. Stat. Ann. §§ 180.04 to .059 (West Supp. 1990); Wyo. Stat. §§ 17-16-850 to -858 (1989).

12. Del. Code Ann. tit. 8, § 145 (1983 & Supp. 1988).

13. RMBCA, *supra* note 1, at §§ 8.50-.58.

14. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 6.02 (1981 & Supp. 1985).

15. 173 Misc. 106, 16 N.Y.S.2d 844 (1939).

16. *Id.*

17. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 5.08 (1981 & Supp. 1990).

18. *Id.* at ¶ 6.02.

19. *Id.* at ¶ 6.03[2], [3].

20. Hazen, *Corporate Directors' Accountability: The Race To The Bottom - The Second Lap*, 66 N.C.L. Rev. 171, 177 (1987) [hereinafter *The Race To The Bottom]*; *cf.* Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 Bus. Law at 1221-1227; Heyler, *Indemnification of Corporate Agents*, 23 UCLA L. Rev. 1255, 1255 (1976) (referring primarily to the early development of indemnification in California); Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1081.

21. Until recently, indemnification in shareholder derivative lawsuits was limited

expense[23] provisions directly affects executives who face criminal liability.

Virtually all indemnification statutes follow the same general pattern: they require corporations to indemnify directors in some instances but permit indemnification in other instances as long as certain standards of conduct are met.[24] All of the statutes set forth a procedure for authorizing indemnification and indicate whether the statute is the exclusive mechanism for providing indemnification.

Thirty statutes are purely nonexclusive, and thus allow corporations to indemnify executives in circumstances other than those set forth in the statute.[25] No statutes are truly exclusive but two, those of Minnesota and North Dakota, come close. Although these statutes give corporations the authority to limit the indemnification provided in the statute, they

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to expenses of a successful defense and was not available for judgments. North Carolina, Virginia, Indiana and Wisconsin all exemplify the trend of allowing indemnification for settlements or even judgments in derivative lawsuits. For a discussion of this trend see Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 Bus. Law at 1221-24.

22. *See, e.g.*, Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 Bus. Law at 1224-27; Note, *Protecting Corporate Directors and Officers: Indemnification*, 40 Vand. L. Rev. 737, 758 (1987); *cf.* Heyler, *supra* note 20, 23 UCLA L. Rev. at 1266 (referring primarily to the early development of indemnification law in California).

23. *Cf.* Heyler, *supra* note 20, 23 UCLA L. Rev. at 1263-64 (referring primarily to the early development of indemnification law in California).

24. There are a few exceptions to this pattern. The Connecticut, Minnesota, North Dakota, and Wisconsin statutes provide only for mandatory indemnification. Conn. Gen. Stat. Ann. §§ 33-320a(b) and (c) (West 1987); Minn. Stat. Ann. § 302A.521 (West 1985 & Supp. 1990); N.D. Cent. Code § 10-19.1-19.(2) (1985); Wis. Stat. Ann. § 180.042 (West Supp. 1990). The Massachusetts and Vermont statutes provide only for permissive indemnification. Mass. Gen. Laws Ann ch. 156B, § 67 (West 1990 & Supp. 1990); Vt. Stat. Ann. tit. 11, § 1852(15) (1984).

25. Ala. Code § 10-2A-21(f) (1987); Alaska Stat. § 10.06.490(a) (1989); Ariz. Rev. Stat. Ann. § 10.005(F) (1990); Ark. Stat. Ann. § 4-26-814(F) (1987); Cal. Corp. Code § 317(g) (West 1987 & Supp. 1990); Del. Code Ann. tit. 8, § 154(f) (1983 & Supp. 1988); Haw. Rev. Stat. § 415-5(g) (1985 & Supp. 1989); Idaho Code § 30-1-5(f) (1980 & Supp. 1989); Ill. Ann. Stat. ch. 32, para. 8.75(f) (Smith-Hurd 1985 & Supp. 1989); Ind. Code Ann. § 23-1-37-15(a) (West 1989); Kan. Stat. Ann. § 17-6305(f) (1988); Ky. Rev. Stat. Ann. § 271B.8-580 (Michie/Bobbs-Merrill, 1989); La. Rev. Stat. Ann. § 12:83(E) (West 1969 & Supp. 1990); Me. Rev. Stat. Ann. tit. 13A, § 719(5) (1981 & Supp. 1989); Md. Corps & Ass'ns Code Ann. § 2-418(g) (1985 & Supp. 1989); Mass. Gen. Laws Ann. ch. 156B, § 67 (West 1970 & Supp. 1990); Mich. Comp. Laws Ann. § 450.1565 (West 1990); Mo. Ann. Stat. § 351.355 subd. 6 (Vernon 1966 & Supp. 1990); N.H. Rev. Stat. Ann. § 293-A:5(VI) (Supp. 1987); N.J. Stat. Ann. § 14A:3-5(8) (West 1969 & Supp. 1990); N.M. Stat. § 53-11-4.1(B) (1983 & Supp. 1989); Ohio Rev. Code Ann. § 1701.13(E)(6) (Baldwin 1986 & Supp. 1989); Okla. Stat. Ann. tit. 18, § 1031(F) (West 1986 & Supp. 1990); Or. Rev. Stat. § 60.414(1) (1988); S.D. Codified Laws Ann. § 47-2-58.6 (1983 & Supp. 1990); Utah Code Ann. § 16-10-4(f) (1987 & Supp. 1990); Vt. Stat. Ann. tit. 11, § 1852(15) (1984); Wash. Rev. Code Ann. § 23B.08.560(2) (Supp. 1990). *But see infra* note 26; W. Va. Code § 31-1-9(f) (1988); Wyo. Stat. § 17-16-858 (1989).

do not allow corporations to expand indemnification rights beyond those set forth in the statute.[26] A few statutes present a hybrid approach on the exclusivity issue. Nine of the statutes professing to be nonexclusive appear to place some restrictions on indemnification made outside the statute.[27] Another nine statutes,[28] following the RMBCA,[29] prohibit in-

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26. The pertinent language in these two statutes is identical: "The articles or bylaws either may prohibit indemnification or advances of expenses otherwise required by this section or may impose conditions on indemnification or advances of expenses in addition to the conditions [imposed by this statute] . . . ." MINN. STAT. ANN. § 302A.521 subd. 4 (West 1985 & Supp. 1990); N.D. CENT. CODE, § 10-19.1-91.(5) (1985).

27. For example, New York's incorporation statute provides that

> [t]he indemnification and advancement of expenses granted pursuant to, or provided by, this article shall not be deemed exclusive of any other rights . . . contained in the certificate of incorporation or the by-laws, or . . . a resolution of shareholders, . . . a resolution of directors, or . . . an agreement . . . provided that no indemnification may be made . . . if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated.

N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1990). The following state incorporation codes also purport to be exclusive but impose similar restrictions: FLA. STAT. ANN. § 607.014(6) (West 1986 & Supp. 1989); IOWA CODE ANN. § 496A.4A(7) (West Supp. 1990); MISS. CODE ANN. § 79-4-8-8.58 (1972 & Supp. 1988); NEV. REV. STAT. § 78.751(6) (Michie 1987); 15 PA. CONS. STAT. ANN. § 1746(b) (Purdon 1990); TENN. CODE ANN. § 48-18-509 (1988 & Supp. 1989); VA. CODE ANN. § 13.1-704 (1989); and WIS. STAT. ANN. § 180.049 (West & Supp. 1990).

The Washington incorporation statute uses this approach when the indemnification at issue is authorized by the articles of incorporation, bylaws or a resolution adopted or ratified by the shareholders. In these situations a corporation is not limited by the indemnification statute except that no indemnity is available to a director whose acts or omissions have been "finally adjudged to be intentional misconduct or a knowing violation of law," or were regarding "unlawful distributions," or any transaction in which it was finally adjudged that such director personally received a benefit to which he was not entitled. WASH. REV. CODE ANN. § 23B.08.560(1) (Supp. 1990). However, when the corporation grants indemnification through a mechanism other than the articles of incorporation, bylaws or a resolution adopted or ratified by shareholders, Washington's statute is nonexclusive and corporations are not bound by it. WASH. REV. CODE ANN. § 23B.08.560(2) (Supp. 1990). Thus, for example, it would appear that a corporation would not be bound by the limits in the incorporation statute when it negotiated a contract with an executive for indemnification.

28. COLO. REV. STAT. § 7-3-101.5 (1990); CONN. GEN. STAT. ANN. § 33-320(g) (West 1987); GA. CODE ANN. § 14-2-859 (1989); MONT. CODE ANN. § 35-1-414(7) (1989); NEB. REV. STAT. § 21-2004(15)(f) (1987); N.C. GEN. STAT. § 55-8-58 (1990); R.I. GEN. LAWS § 7-1.1-4.1.(g) (1985 & Supp. 1989); S.C. CODE ANN. § 33-8-580(a) (Law. Co-op. 1990); TEX. BUS. CORP. ACT ANN. art. 2.02-1.(M) (Vernon 1980 & Supp. 1990). Some of these statutes impose requirements additional to the consistency requirement which may affect the convicted executive. For example, North Carolina further provides that corporations may not indemnify any person for "activities which were at the time taken

demnification that is "not consistent with" the provisions of the statute.[30]

Virtually all of the statutes address two additional issues, advancement of attorneys fees and purchase of D&O insurance. All statutes, except Vermont's,[31] specifically allow corporations to advance funds to pay attorneys fees as those fees are incurred, rather than after judgment. Every state indemnification statute, except Vermont's, specifically authorizes corporations to procure D&O liability insurance without regard to whether the corporation has the power to indemnify.[32]

In states where the indemnification statute is nonexclusive, corporations may pass bylaws or corporate resolutions or negotiate contracts with individual executives allowing indemnification. These bylaws, resolutions or contracts may allow indemnification beyond that permitted in the statute. Bylaws and corporate resolutions tend to favor corporate executives.[33] Most seek to expand the benefits of indemnification to directors and officers in "new and unexpected ways."[34] As might be

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known or believed . . . to be clearly in conflict with the best interests of the corporation." N.C. Gen Stat. § 55-8-57) (1990).

29. RMBCA, *supra* note 1, at § 8.58(a).

30. Section 8.58(a) of the RMBCA provides that

> [a] provision treating a corporation's indemnification of or advance for expenses to *directors* that is contained in its articles of incorporation, bylaws, a resolution of its shareholders or board of directors, or in a contract or otherwise, is valid only if and to the extent the provision is consistent with this subchapter. If articles of incorporation limit indemnification or advance for expenses, indemnification and advance for expenses are valid only to the extent consistent with the articles.

Id. (emphasis added). As can be seen, the above provision governs corporations' extra-statutorial powers to indemnify directors.

Section 8.56(3) governs corporations' extra-statutorial powers to indemnify officers, employees and agents who are not directors. It provides that a corporation may indemnify these individuals through its articles of incorporation, bylaws, general or specific action of its board of directors, or contracts that are "consistent with public policy." *Id.* § 8.56(3).

31. Vt. Stat. Ann. tit. 11, § 1852(15) (1984).

32. *Id.*

33. For example, Delaware's statute provides in full:

> A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under the provision of this section.

Del. Code Ann. tit. 8, § 145(g) (1983 & Supp. 1988). The provisions of most other state statutes mirror Delaware's provision.

34. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 7.06 (1981 & Supp. 1988); *id.* at ¶ 7.03.

imagined, ad hoc agreements negotiated between corporations and individual executives allow for the broadest discretion to negotiate terms of full indemnification. To date, the only requirement imposed by the courts on such contracts is that new and independent consideration must support the agreement. Courts have liberally construed what suffices as "new and independent" consideration.[35]

B. *THE INDEMNIFICATION STATUTES*

1. *Mandatory Indemnification*

All but six state incorporation statutes make indemnification mandatory when an executive has been successful in defending against criminal charges,[36] but these statutes differ in their description of "success." California's statute requires that the executive must be "successful on the merits."[37] Twenty-eight state statutes require that the executive be "successful on the merits or otherwise,"[38] while fifteen statutes require that the executive be "wholly successful on the merits or otherwise."[39]

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35. The only requirement the courts have imposed thus far on such agreements is that new and independent consideration to that already negotiated between the parties support the agreement. *See, e.g.*, Koster v. Warren, 176 F. Supp. 459, 461-462 (N.D. Calif. 1959), *aff'd*, 297 F.2d 418 (9th Cir. 1961) (and cases cited therein); Choate, Hall & Stewart v. SCA Services, Inc., 22 Mass. App. 522, 495 N.E.2d 562, 565 n.7 (1986); Mooney v. Willys-Overland Motors, 204 F.2d 888, 891 (3d Cir. 1953).

36. Of these six, Massachusetts and Vermont provide only for permissive indemnification. MASS. GEN LAWS ANN. ch. 156B, § 67 (West 1970 & Supp. 1990); VT. STAT. ANN. tit. 11, § 1852 (15) (1984). Connecticut, Minnesota, North Dakota, and Wisconsin, statutes which provide for mandatory indemnification only, use as their standards for mandatory indemnification what most statutes use as standards for permissive indemnification. CONN. GEN. STAT. ANN. § 33-320a(b) and (c) (West 1987); MINN. STAT. ANN. § 302A.521 (West 1985 & Supp. 1990); N.D. CENT. CODE § 10-19.1-9.1(2) (1985); WIS. STAT. ANN. § 180.042 (West & Supp. 1990).

37. CAL. CORP. CODE § 317(d) (West 1977 & Supp. 1990).

38. The incorporation statutes of the following states use the "successful on the merits" standards for mandatory indemnification: Alabama, Alaska, Arizona, Arkansas, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Kansas, Louisiana, Maine, Maryland, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, South Dakota, Utah, West Virginia, Wisconsin. *See supra* note 11 for state statutory citations.

39. Following the lead of the RMBCA, the incorporation statutes of the following states use the "wholly successful on the merits or otherwise" standard for mandatory indemnification: Colorado, Indiana, Iowa, Kentucky, Mississippi, Montana, New Mexico, North Carolina, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Washington, Wyoming. *See* RMBCA, *supra* note 1, at § 8.52. *See supra* note 11 for state statutory citations.

Virginia uses different language but to the same effect. Virginia's statute provides that "[u]nless limited by its articles of incorporation, a corporation shall indemnify a

The decision in *Merritt-Chapman & Scott Corp. v. Wolfson*[40] highlights the significance of the "wholly successful" requirement. An executive of Merritt-Chapman pled guilty to filing false annual reports with the SEC and New York Stock Exchange. In return, the government agreed to dismiss the remaining charges pending against him. Another Merritt-Chapman executive, who was convicted of perjury before the SEC, promised not to appeal his conviction in exchange for dismissal of other charges pending against him.[41] The two executives sought and received pro rata reimbursement for the attorneys fees associated with the dismissed charges. The trial court approved this reimbursement, reasoning that "in a criminal action, any result other than conviction must be considered a success."[42]

After the *Merritt-Chapman* decision, the RMBCA added the word "wholly" to its standard for mandatory indemnification. The Official Comments to the RMBCA indicate that this change was made "to avoid the argument accepted in *Merritt-Chapman* . . . that a defendant may be entitled to partial mandatory indemnification if he succeeded by plea bargaining or otherwise to obtain a dismissal of some but not all counts of an indictment."[43] Thus, to qualify for mandatory indemnification in states using the "wholly successful" language, the executive must secure an acquittal or dismissal of *all* charges.

Whether a statute mandates indemnification when one has been successful "on the merits" or "on the merits or otherwise" depends upon how the drafters felt about victories on procedural grounds. Those drafters who believed that executives should not be forced to forego a viable procedural defense simply to collect indemnification, included the language "on the merits or otherwise."[44] In these states a dismissal of charges for reasons wholly unrelated to guilt or innocence still entitles the executive to indemnification. The drafters of the California Code which requires "success on the merits" before one qualifies for mandatory indemnification, did not specifically address this rationale but generally indicated their belief that the "success on the merits" standard properly balanced the need for indemnification while also protecting the shareholders.[45]

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director who entirely prevails in the defense of any proceeding . . . ." VA. CODE ANN. § 13.1-698 (1989). The Official Comments to the Virginian statute state that this change in language from the RMBCA was not intended to alter the result under the RMBCA. *Id.*

40. 321 A.2d 138 (Del. Super. Ct. 1974).

41. *Id.* at 140.

42. *Id.* at 141.

43. RMBCA, *supra* note 1, at § 8.52 (Official Comment).

44. *Id.*

45. *Cf.* CAL. CORP. CODE § 317 (West 1977) (Legislative Committee Comment (1975)).

It is not clear how much sense these standards for mandatory indemnification make when applied. For example, the requirement that an executive be "wholly successful" overlooks the discretion and variation in how identical offenses are charged, and negotiated.[46] Mail fraud[47] demonstrates why this is so. The first count in most mail fraud indictments details the alleged scheme to defraud and the defendant's role in it. Subsequent counts of the indictment incorporate, by reference, all allegations in the first count and simply allege that the defendant caused a different mailing in furtherance of the scheme to defraud.[48] Every count in the indictment carries a possible maximum term of imprisonment of five years, a possible maximum fine of $250,000, or both.[49] In most mail fraud cases, there are many mailings, often hundreds, that could be included as separate counts in the indictment.

Prosecutors vary tremendously in how they charge mail fraud, and in how they negotiate plea agreements with defendants.[50] One prosecutor may charge five counts in a mail fraud indictment and agree to dismiss three counts in return for a plea of guilty on two counts. This convicted executive would be entitled to sixty percent indemnification in a jurisdiction not imposing the "wholly successful" requirement, because the executive was "successful" on sixty percent of the charges. Another prosecutor may charge the same mail fraud scheme in twenty counts and agree to dismissal of nineteen counts; under the same indemnification statute, the convicted executive would now be entitled to ninety-five percent indemnification. Still another prosecutor may charge the same mail fraud scheme in one count and dismiss nothing; in this instance, again under the same indemnification statute, the convicted executive is not entitled to any indemnification. In each of these hypothetical cases, the evidence of fraud and the defendant's culpability are the same but, because of the different practices of prosecutors, the convicted executives are entitled to widely varying amounts of indemnification.

The requirement that one be "wholly successful" also presents the major example of when indemnification is not, but should be, allowed. Assume there is an indictment against a single corporate executive charg-

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46. For sources discussing the discretion accorded prosecutors in charging offenses and negotiating plea agreements see, e.g., Rakoff, *The Exercise of Prosecutorial Discretion in Federal Business Fraud Prosecutions*, in CORRIGIBLE CORPORATIONS AND UNRULY LAW 173 (Fisse & French ed. 1985); Vorenberg, *Decent Restraint of Prosecutorial Discretion*, 94 HARV. L. REV. 1521 (1981); LaFave, *The Prosecutor's Discretion in the United States*, 18 AM. J. COMP. L. 532 (1970).

47. 18 U.S.C. § 1341 (1984 & Supp. 1990).

48. United States Attorneys' Manual § 43.410 (1988).

49. 18 U.S.C. § 1341 (1984 & Supp. 1990) (regarding term of imprisonment); 18 U.S.C. § 3571(a)(3) and (e) (Supp. 1990) (regarding fine).

50. *See supra* note 46.

ing the executive with RICO, mail fraud, and tax offenses. RICO is a felony which carries a possible maximum fine of $250,000, a possible maximum term of prison of twenty years, and mandatory forfeiture of all assets acquired or maintained in violation of the RICO statute.[51] As noted, mail fraud, also a felony, carries a possible maximum term of imprisonment of five years and a possible maximum fine of $250,000 or both.[52] The tax offense is a misdemeanor and carries a possible maximum term of imprisonment of one year, a possible maximum fine of $10,000, or both.[53] Assume that the jury acquits the executive on the more serious RICO and mail fraud charges but convicts on the misdemeanor tax offense. Because the executive has escaped potential imprisonment of twenty-five years, fines of $500,000 and forfeiture of assets, most observers would agree that such a result is a virtual vindication. Despite the fact that the attorneys fees are no doubt enormous after a complex trial on three such charges, if the defendant is in a jurisdiction that requires one to be "wholly successful" to receive indemnification, the executive will not qualify for mandatory indemnification, even on a pro-rata basis. By comparison, if the defendant is in a jurisdiction that simply requires "success," it is likely he would qualify for almost total mandatory indemnification.

The addition of "or otherwise" in the standard, "successful on the merits or otherwise," appropriately recognizes that it makes no sense to force an executive charged with criminal offenses to forego a successful procedural defense, simply to qualify for mandatory indemnification. However, trying to apply the "on the merits" or the "on the merits or otherwise" standards can be difficult. It is not at all clear what qualifies, or should qualify, as prevailing "on the merits." Most observers would agree that pretrial dismissals for expired statute of limitations, lack of venue, double jeopardy, or improper pleading of charges are procedural and therefore not victories "on the merits." However, dismissals for prosecutorial misconduct, government's refusal to reveal an informant's identity or other discoverable information, arguably are "on the merits" and should qualify for mandatory indemnification.

When the corporate officials charged with authorizing indemnification are friendly to the executive seeking indemnification, it will not matter to the executive whether or not the executive qualifies for mandatory indemnification. The friendly authorizing individuals have several ways by which they can award their colleague indemnification: they can con-

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51. Racketeer-Influenced and Corrupt Organizations (RICO), 18 U.S.C. § 1963 (Supp. 1990) (regarding forfeiture and imprisonment); Alternative Fine Provision, 18 U.S.C. § 3571(a)(3) and (e) (Supp. 1990) (regarding fine).

52. *See supra* note 49.

53. Fraudulent Returns, Statements, or Other Documents, 26 U.S.C. § 7207 (1989).

strue the statutory standard for mandatory indemnification generously; they can find that their colleague qualifies under the statutory permissive standard; if the statute is nonexclusive, they can indemnify their fallen comrade pursuant to bylaws, resolutions or contracts, none of which are bound by the statutory standards. Qualifying for mandatory indemnification will be vital, however, when the authorizing officials are hostile to the executive or otherwise unwilling to construe the statute in the executive's favor. The need for statutory clarity in such circumstances is evident. As presently drafted, however, these standards are not clear, and because they fail to account for the way the criminal law is actually administered, they have the potential to operate unfairly.

2. Permissive Indemnification

For those executives who have been convicted on criminal charges and do not qualify for mandatory indemnification, indemnification may still be available if these executives can qualify for permissive indemnification.[54] There are potentially eight different provisions in the various incorporation statutes that determine whether a corporation is permitted to indemnify a convicted executive. Although no incorporation statute directly permits reimbursement for criminal fines, penalties, or attorneys fees incurred in the unsuccessful defense of the criminal charges, the combination of these provisions makes it quite possible for a corporation to indemnify convicted executives. The following five provisions are included in almost every state's incorporation statute: (1) a standard for permissive indemnification (2) a procedure for authorizing indemnification, (3) a provision addressing the exclusivity of the statutory standards, (4) a statement regarding the authority to advance expenses, and (5) a statement of the significance to be accorded a conviction or plea of nolo contendere. Additionally, the following three provisions are variously included in some state incorporation statutes: (1) power given a court to indemnify executives who have not met the statutory standards for indemnification, (2) shareholder disclosure requirements, and (3) miscellaneous restrictions.

a. The standard for permissive indemnification

Forty-four incorporation statutes contain essentially the same three criteria that a convicted corporate executive must meet before a cor-

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54. In some states, corporate executives will have still other avenues for obtaining indemnification when they do not qualify for mandatory indemnification. *See infra* text accompanying the following notes: notes 54-131 (permissive indemnification), notes 143-198 (avenues outside the incorporation statute when the statute is nonexclusive), notes 199-209 (advancing of expenses), notes 214-215 (power given courts to order indemnification when statutory standards are not met).

poration may indemnify this executive for attorneys fees, fines or penalties.[55] The first criterion, shared by all forty-four states, requires that the executive "acted in good faith." There is a slight variation among the states as to the second criterion. California's statute requires that the person seeking indemnification "acted in a manner the person reasonably believed to be in the best interests of the corporation."[56] Twenty-six statutes broaden this second criterion by requiring only that the executive "acted in a manner he reasonably believed to be in or not opposed to the best interest of the corporation."[57] Some states retain California's version when the executive was acting "in his official capacity with the corporation" but allow a variation of the latter version[58] "in all other cases."[59] "All other cases" includes situations such as requests by the indemnifying corporation that its executive serve as a director for a related or charitable corporation. Two states, Georgia and Virginia, have altered this second criterion by deleting the reasonableness requirement.[60] Thus, in these two states the executive must simply show that he truly believed that his conduct was in the best interests of the corporation; the executive does not have to show that his belief was reasonable. The third criterion is imposed only when the executive is seeking indemnification for costs arising from a criminal proceeding. Forty-three statutes allow indemnification to a convicted executive if the executive "had no reasonable cause to believe that his conduct was unlawful."[61]

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55. The six statutes that do not use these general criteria for permissive indemnification are Massachusetts, Vermont, Connecticut, Minnesota, North Dakota and Wisconsin. To some extent, however, the *mandatory* standards of Connecticut, Minnesota, North Dakota and Wisconsin incorporate some or all of the three criteria used by the other forty-four states for *permissive* indemnification. *See supra* note 11 for statutory citations.

56. Cal. Corp. Code § 317(b) (West 1977 & Supp. 1990).

57. Alabama, Alaska, Arizona, Arkansas, Delaware, Florida, Hawaii, Idaho, Illinois, Kansas, Louisiana, Maine, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Utah, West Virginia, Wyoming. *See supra* note 11 for statutory citations.

58. *See, e.g.*, RMBCA § 8.51(a)(2) (1984). Instead of using the language "reasonably believed to be in or not opposed to the best interests of the corporation," the RMBCA uses "reasonably believed was in [or] was *at least* not opposed to [the] best interests [of the corporation]." *Id.* (emphasis supplied). The Official Comments to this section state that this change was made to "make it clear that this test is an outer limit for conduct." 2 Model Business Corp. Act Ann., at 1114 (3d ed. & Supp. 1988).

59. Colorado, Indiana, Iowa, Kentucky, Maryland, Mississippi, Montana, New Mexico, New York, North Carolina, Rhode Island, South Carolina, Tennessee, Texas, Washington, Virginia. *See supra* note 11 for statutory citations.

60. Ga. Code Ann. § 14-2-851(a) (1989); Va. Code Ann. § 13.1-697(a) (1989).

61. The states using this criterion for permissive indemnification are Alabama,

It will not be difficult for a corporation that wants to indemnify its executives who have been convicted of crimes to find that these criteria are met, despite the convictions. To understand why, it is necessary to turn from corporate to criminal law. With some crimes there is a gray area between legal and illegal conduct.[62] The jurisprudence of white collar crime, in particular, is littered with examples of courts and legislatures struggling to clarify what is or is not a crime. RICO[63] cases present the most stunning example, for the federal courts have continuously disagreed with each other over what constitutes legal and illegal conduct under the RICO statute.[64] The Supreme Court's decisions in

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Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wyoming. *See supra* note 11 for statutory citations. Indiana phrases this criterion as follows:

> the individual [seeking indemnification costs related to a criminal proceeding] either:
>
> (A) had reasonable cause to believe the individual's conduct was lawful; or
>
> (B) had no reasonable cause to believe the individual's conduct was unlawful.

IND. CODE ANN. § 23-1-37-8(a)(3) (West 1989).

62. For discussions of this "gray area" see *White Collar Crime: Hearing Before the Senate Comm. on the Judiciary*, 99th Cong., 2d Sess. 192 (Part I) [hereinafter *White Collar Crime Hearing*] (testimony of Kenneth E. Carlson) ("With a white collar crime it is often hard to tell whether a particular action is a crime."); A REISS & A. BIDERMAN, DATA SOURCES ON WHITE-COLLAR LAW BREAKING 2 (1980) ("There is little justification . . . for distinguishing between civil and criminal fraud on grounds of culpability or seriousness of sanctions," because the only real differences between criminal and civil actions are in the "standards and procedures by which violations are determined and sanctions imposed.").

63. Racketeer Influenced and Corrupt Organizations (RICO), 18 U.S.C. §§ 1961-68 (1984 & Supp. 1990).

64. The Supreme Court's decision in H. J., Inc. v. Northwestern Bell Telephone Co., ____U.S. ____, 109 S. Ct. 2893, 106 L. Ed. 2d 195 (1989) laid to rest one such disagreement among the courts. At issue was the meaning of "pattern of racketeering activity," which is an element that must be proven in any RICO case. Until this decision the United States Court of Appeals for the Eighth Circuit enforced a narrow interpretation of this element, construing it to mean that two counts (i.e., two mailings) in a mail fraud scheme were so closely related that they constituted only one "racketeering activity," not a "pattern of racketeering activity." All of the other federal courts of appeals had rejected this interpretation (*see, e.g.*, United States v. Indelicato, 865 F.2d 1370 (2d Cir. 1989)), when the Supreme Court also rejected it in *H. J., Inc.* Until the Supreme Court resolved this controversy, RICO plaintiffs who intended to allege mail fraud as the "racketeering activity" were uncertain as to whether they could plead a sufficient "pattern of racketeering activity."

The federal courts are still in disagreement over other fundamental issues in RICO law such as, what suffices to prove an "enterprise," *compare* United States v. Bledsoe,

the fraud cases of *United States v. McNally*[65] and *Williams v. United States*[66] also present dramatic examples. In both cases the Supreme Court reversed convictions and held that conduct considered to be criminal (and successfully prosecuted) for many years was not criminal.[67] Payments between health care providers is another glaring example. The federal courts of appeal have continuously disagreed over whether certain long-standing payment practices between providers are illegal under kickback statutes.[68] If the courts cannot agree among themselves, or with legislatures, as to whether the line between legal and illegal conduct has been crossed, it is certainly understandable that corporate officials who must determine eligibility for indemnification could find that a corporate executive had no "reasonable cause to believe that his conduct was unlawful."[69]

A second reason it will not be difficult for a corporation to find that a convicted corporate executive has met the standards for permissive indemnification, is the increasingly wide latitude allowed the government in proving the mens rea element, especially in white collar criminal cases. It is commonly assumed that proof of intention to violate the law distinguishes a criminal from a civil matter.[70] If proof of such intent

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674 F.2d 647, 663-65 (8th Cir.), *cert. denied sub nom.* Phillips v. United States, 459 U.S. 1040 (1982) *with* United States v. Bagnariol, 665 F.2d 877, 890-91 (9th Cir. 1981), *cert. denied*, 456 U.S. 962 (1982), and whether an "enterprise" may also be a "person" under RICO, *compare* United States v. Hartley, 678 F.2d 961, 988 (11th Cir. 1982), *cert. denied*, 459 U.S. 1170 (1983) *with* Bennett v. United States Trust Co. of New York, 770 F.2d 308, 315 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986).

65. 483 U.S. 350, 107 S. Ct. 2875, 97 L. Ed. 2d 292 (1987).

66. 458 U.S. 279, 102 S. Ct. 3088, 73 L. Ed. 2d 767 (1982).

67. *McNally*, 483 U.S. at 361, 107 S. Ct. at 2882, 97 L. Ed. 2d at 303; *Williams*, 458 U.S. at 284, 102 S. Ct. at 3091; 73 L. Ed. 2d at 773.

68. *See* Bucy, *Fraud by Fright: White Collar Crime By Health Care Providers*, 67 N.C.L. Rev. 855, 915-916 (1989) and cases cited therein.

69. In fact, Indiana explicitly cited this "gray area" between legal and illegal conduct when it passed standards for permissive indemnification that make it even easier for convicted corporate executives to qualify for permissive indemnification. Indiana's incorporation statute now provides that a convicted executive qualifies for permissive indemnification if he "either . . . had reasonable cause to believe [his] conduct was lawful; or had no reasonable cause to believe [his] conduct was unlawful." Ind. Code Ann. § 23-1-37-8(a)(3) (West 1989).

The Official Comment to Indiana's provision explains that this change was intended to favor the executive. The Comment notes that in complex modern corporate and securities transactions "a corporate director or officer . . . may well have reasonable cause to believe his action is 'lawful' even though he cannot categorically say, given the 'gray areas' in a particular statute or regulation, that he has 'no reasonable cause' to believe that the action may finally be determined to be 'unlawful.'" Ind. Code Ann. § 23-1-37-8 Official Comment (West 1989).

70. H.L.A. Hart, Punishment and Responsibility 187 (1968) ("In all advanced

was literally required to convict corporate executives, such executives would rarely qualify for permissive indemnification, even under the friendliest application of these standards. However, if a defendant is found guilty under a strict liability standard, which requires no proof of mens rea,[71] or under a negligence or recklessness mens rea standard, it is not particularly difficult for corporate officials who want to indemnify convicted colleagues to find that their colleagues acted in "good faith," reasonably believing their conduct was in the "best interest of the corporation" (or in some states, "at least not opposed to the best interests"), and "had no reason to believe [their] conduct was unlawful."

In recent years, prosecution of strict liability offenses involving corporate executives has increased. Strict liability offenses were created in response to the danger to health and safety posed by the industrial revolution.[72] As the potential dangers from corporate action have increased, courts and legislatures have expanded strict liability offenses.[73] Congress has passed the Federal Food, Drug, and Cosmetic Act,[74] the Refuse Act,[75] and the Public Health Service Act,[76] all of which impose

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legal systems liability to conviction for serious crimes is made dependent, not only on the offender having done those outward acts which the law forbids, but on his having done them in a certain frame of mind or with a certain will . . . . Lawyers of the Anglo-American tradition use the Latin phrase *mens rea* (a guilty mind) as a comprehensive name for those necessary mental elements . . . ."). *See also* J. HALL, GENERAL PRINCIPLES OF CRIMINAL LAW 11-13 (1947); Lee, *Corporate Criminal Liability*, 28 COLUM. L. REV. 1 (1928). Considerable efforts have been devoted to defining "intent" or "mens rea." *See, e.g.*, H.L.A. HART, PUNISHMENT AND RESPONSIBILITY, *supra*, at 136-157; 1 BISHOP, CRIMINAL LAW § 287 (9th ed. 1930). For purposes of this Article, mens rea is used to signify "the mental element necessary to convict for any crime." Sayre, *Mens Rea*, 45 HARV. L. REV. 974 n.1 (1932).

71. With strict liability offenses, criminality is based only upon external behavior and irrespective of intent. Sayre, *Public Welfare Offenses*, 33 COLUM. L. REV. 55 (1933).

72. Morissette v. United States, 342 U.S. 246, 253-255, 72 S. Ct. 240, 96 L. Ed. 2d 288 (1952); Sayre, *Public Welfare Offenses*, *supra* note 71, 33 COLUM. L. REV. at 68.

73. Weiss-Malik, *Imposing Penal Sanctions on the Unwary Corporate Executive: The Unveiled Corporate Criminal*, 17 U. TOL. L. REV. 383, 387 (1986); McCormack, *The Tightening White Collar: Expanding Theories of Criminal Liability for Corporate Executives, Directors, and Attorneys*, 49 TEX. B.J. 494, 499 (1986); Metzger, *Corporate Criminal Liability for Defective Products: Policies, Problems, and Prospects*, 73 GEO. L.J. 1, 2-3 (1984); Brickey, *Criminal Liability of Corporate Officers for Strict Liability Offenses - Another View*, 35 VAND. L. REV. 1337, 1337-1338 (1982). *But see* Abrams, *Criminal Liability of Corporate Officers For Strict Liability Offenses - A Comment on Dotterweich and Park*, 28 UCLA L. REV. 463 (1981) (suggesting that criminal liability in these cases is based upon a finding of culpability, not strict liability).

74. 21 U.S.C. §§ 301-392 (1972 & Supp. 1990).

75. 33 U.S.C. § 407 (1986).

76. 42 U.S.C. §§ 261, 262 (1982 & Supp. 1990).

strict liability for criminal offenses. Since the Supreme Court's 1943 decision in *United States v. Dotterweich*,[77] courts also have been increasingly willing to hold corporate executives strictly liable for acts of their agents, even though the executives did not participate in the acts or have personal knowledge of them.[78]

United States v. Park[79] is perhaps the premiere decision demonstrating this expansive liability of corporate executives. Park was the Chief Executive Officer of ACME, a large national retail food chain with 36,000 employees, 16 warehouses, and 874 retail outlets.[80] ACME and Park were convicted for violations of the Food, Drug, and Cosmetic Act (FDCA) because of unsanitary conditions in one of the company warehouses.[81] The evidence indicated that Park was aware of the unsanitary conditions but had delegated the responsibility for remedying the situation to a corporate vice-president.[82] Convicted by a jury, Park secured a reversal from the court of appeals[83] only to see the Supreme Court reinstate his conviction.[84] The Supreme Court noted that "'[i]n the interest of the larger good,'"[85] the FDCA dispensed with the "'conventional requirement for criminal conduct—awareness of some wrongdoing.'"[86] It did so by imposing a duty on corporate executives to seek out and remedy violations, and to "implement measures that will insure that violations will not occur."[87] In affirming Park's conviction, the Supreme Court relied upon a long line of cases that approved criminal liability of managerial officers who had no knowledge of, or personal participation in, criminal acts, but who had a sufficient relationship to the corporation that they "had the power to prevent the act complained of."[88]

In addition to increased use of strict liability offenses, there is another trend in the criminal law, especially with regard to white collar prosecutions, that should make it easy to find that a convicted executive has met the standard for permissive indemnification. The courts have become increasingly receptive to allowing an inference of criminal mens

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77. 320 U.S. 277, 64 S. Ct. 134, 88 L. Ed 492 (1943).
78. *Id.* at 280-81, 64 S. Ct. at 136, 88 L. Ed at 51-52.
79. 421 U.S. 658, 95 S. Ct. 1903, 44 L. Ed. 2d 489 (1975).
80. *Id.* at 660, 95 S. Ct. at 1905, 44 L. Ed. 2d at 494.
81. *Id.* at 662-66, 95 S. Ct. at 1906-1908, 44 L. Ed. 2d at 495-97.
82. *Id.* at 663-64, 95 S. Ct. at 1907-1908, 44 L. Ed. 2d at 496.
83. *Id.* at 666, 95 S. Ct. at 1908, 44 L. Ed. 2d at 497.
84. *Id.* at 667, 95 S. Ct. at 1909, 44 L. Ed. 2d at 498.
85. United States v. Park, 421 U.S. 658, 668, 95 S. Ct. 1903, 1909-10, 44 L. Ed. 2d 489, 498-99. (1975) (quoting United States v. Dotterweich, 320 U.S. 277, 280-81 (1943)).
86. 421 U.S. at 668, 95 S. Ct. at 1909, 44 L. Ed. 2d at 498.
87. *Id.* at 672, 95 S. Ct. at 1911-12, 44 L. Ed. 2d at 501.
88. *Id.* at 671, 95 S. Ct. at 1911, 44 L. Ed. 2d at 500.

rea from reckless behavior by defendants. It should be noted, at the outset, that courts have cautioned that by permitting such an inference they are not allowing a conviction for recklessness,[89] but one wonders if this difference is lost when corporate officials are making an indemnification decision. The courts' increased willingness to allow inferences of criminal mens rea from recklessness can be seen by examining the evolution of the following four jury instructions that define various issues of intent: (1) specific intent,[90] (2) willfulness,[91] (3) guilty knowledge,[92] and (4) false and fraudulent.[93]

Until recently, most major crimes and certainly most white collar crimes have been viewed as "specific intent" crimes, requiring proof of specific intent to violate the law before one can be convicted.[94] In such cases, the jury is instructed that "specific intent . . . means more than the general intent to commit the act"[95] and that to prove specific intent, the government must demonstrate that "the defendant knowingly did an act which the law forbids, . . . purposely intending to violate the law."[96] The heavy burden this instruction places on the government becomes more obvious when one examines the jury instruction given when the crime is only a "general intent" crime. In "general intent" cases, the jury is instructed that the "law assumes that every person intends the natural consequences of his voluntary acts;" that this general intent may be "inferred from defendant's voluntary commission of the act forbidden by law . . . ;" and, that "it is not necessary to establish that the defendant knew that his act . . . was a violation of law."[97]

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89. *Cf.* United States v. Massa, 740 F.2d 629, 643 (8th Cir. 1984), *cert. denied*, 471 U.S. 1115, 105 S. Ct. 2357, 86 L. Ed. 2d 258 (1985) (In approving this jury instruction, the court rejected Massa's argument that the instruction allowed conviction on an objective or "should have known" theory, rather than on an assessment of Massa's subjective knowledge. The court noted that the jury was repeatedly told that it must find that Massa specifically intended his actions and that the jury was only allowed to infer this intent from Massa's "deliberate indifference.").

90. E. Devitt & C. Blackmar, Federal Jury Practice and Instructions, § 14.03 (3d ed. 1977).

91. *Id.* § 14.06.

92. *Id.* § 14.09.

93. *Id.* § 47.04 (Supp. 1990).

94. *See, e.g.*, United States v. Bohonus, 628 F.2d 1167, 1172 (9th Cir.), *cert. denied*, 447 U.S. 928, 100 S. Ct. 3026, 65 L. Ed. 2d 1122 (1980) (and cases cited therein) (holding that mail fraud, 18 U.S.C. § 1341, is a specific intent crime); United States v. Lange, 528 F.2d 1280, 1288 (5th Cir. 1976) (and cases cited therein) (holding that making a false statement to the government, 18 U.S.C. § 1001, is a specific intent crime).

95. E. Devitt & C. Blackmar, *supra* note 90, § 14.03.

96. *Id.*

97. Seventh Circuit Judicial Conference Committee on Jury Instructions, Manual on Jury Instructions in Federal Criminal Cases, 33 F.R.D. 523, 549-50 (1963).

By the 1970s, some of the federal courts openly criticized the distinction between general and specific intent crimes as obtuse and arcane. For example, in 1979 the United States Court of Appeals for the Seventh Circuit noted that "the labels 'specific intent' and 'general intent' . . . are not enlightening to juries."[98] By 1980 the United States Supreme Court had agreed that the distinction between general intent and specific intent "has been the source of a good deal of confusion."[99] In response, the United States Courts of Appeals for the Seventh,[100] Eighth,[101] and Ninth Circuits,[102] have recommended discontinuing the distinction between general intent and specific intent crimes. They recommend, instead, that "instructions be given which define the precise mental state required by the particular offense charged."[103]

It is interesting to consider the historical and policy significance of the general and specific intent instructions. Sayre, *Mens Rea*, *supra* note 70, 45 Harv. L. Rev. 974 (1932) provides a good background for doing so. In tracing the historical development of the notion of intent, Sayre suggests that gradations of intent (such as "specific intent") developed during the thirteenth to seventeenth centuries but may not be useful in our more modern criminal justice system. *Id.* at 1016-1017.

98. United States v. Arambasich, 597 F.2d 609, 611-613 (7th Cir. 1979) (footnotes & citations omitted):

> We are inclined to agree with the district judge . . . that the labels "specific intent" and "general intent". . . are not enlightening to juries . . . . The stock "specific intent" instructions tendered by [the defendant] are based upon decided cases and have been approved in countless others. Yet they illustrate if not the "variety" or "disparity," the confusion of [judicial] definitions of the requisite but elusive mental element . . . . It is not very helpful to speak of a defendant's purpose to violate the law, as do these stock instructions. Use of the phrase "purposely intending to violate the law" may be erroneously interpreted by jurors, for example, to require that the defendant know his act violates a criminal statute, which is ordinarily unnecessary.

See also Committee on Federal Criminal Jury Instructions, Federal Criminal Jury Instructions of the Seventh Circuit, § 6.02 (1980) [hereinafter Seventh Circuit Pattern Instructions]; Manual of Modern Criminal Jury Instructions for the Ninth Circuit, comments to § 5.04 (1989) [hereinafter Ninth Circuit Pattern Instructions]; Model Penal Code § 2.02 comment, at 125 (Tent. Draft No. 4, 1955) (specific intent is an "awkward term").

99. United States v. Bailey, 444 U.S. 394, 398-414, 100 S. Ct. 624, 628-636, 62 L. Ed. 2d 575, 583-593 (1980), on remand 675 F.2d 1292 (D.C. Cir.), *cert. denied sub nom.* Walker v. United States, 459 U.S. 853, 103 S. Ct. 119, 74 L. Ed. 2d 104 (1982).

100. Seventh Circuit Pattern Instructions, *supra* note 98, § 6.02 ("The Committee recommends avoiding instructions that distinguish between 'specific intent' and 'general intent.'").

101. Manual of Model Criminal Jury Instructions for the District Courts of the Eighth Circuit § 7.01 (1989) [hereinafter Eighth Circuit Pattern Instructions].

102. Ninth Circuit Pattern Instructions, *supra* note 98, at 72. ("The Committee recommends avoiding instructions that distinguish between 'specific intent' and 'general intent.'").

103. *Id.* at 74. *See also* Seventh Circuit Pattern Instructions, *supra* note 98,

The demise of the specific intent instruction has been accompanied by erosion of another instruction that heretofore imposed a heavy mens rea burden on the government. Historically, juries in most criminal cases have been instructed that the government must prove that the defendant acted "willfully," even if "willfully" is not included in the offense charged.[104] Traditionally, "willfully" has been defined as acting "voluntarily and intentionally, and with the specific intent to do something the law forbids; that is to say, with bad purpose either to disobey or to disregard the law."[105] Recently, courts have condemned the "frequent" practice of including willfully in indictments and of instructing juries on willfulness, when this language is not a statutory element.[106] Furthermore, when giving an instruction on willfulness, some courts are using a definition of willfully that omits the strident specific intent language and defines willfully instead, as "intentional disobedience of [the law] *or reckless disregard* of its requirements."[107]

The Supreme Court has suggested a way of determining when this reduced definition of willfully should be used: for "offenses involving moral turpitude," the more stringent definition should be given, but for offenses "denouncing acts not in themselves wrong" the reckless disregard definition should be given.[108] Even this distinction may not wear well, however, for it is in the criminal tax offenses, which are typical malum prohibitum offenses, that the more stringent willfulness definition is still given.[109] Perhaps the only clear thing that can be said about the term

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§ 6.02; Eighth Circuit Pattern Instructions, *supra* note 101, § 7.01. Although Devitt and Blackmar, leading authorities on federal jury instructions, agree with many of the criticisms of the distinction between general and specific intent, they caution the practitioner against discarding the specific intent instruction altogether. ("The authors feel that there is great merit in the suggestions, and will attempt to report instructions applying the Seventh Circuit approach [of discontinuing use of the specific intent instruction] as they appear. There, of course is a danger in discarding established formulation, especially when specific requests are made.") E. Devitt & C. Blackmar, *supra* note 90, § 14.03 notes (Supp. 1990).

104. For reference to this trend see Seventh Circuit Pattern Instructions, *supra* note 98, at § 6.03; Ninth Circuit Pattern Instructions, *supra* note 98, at 76.

105. E. Devitt & C. Blackmar, *supra*, note 90, § 14.06; United States v. Patrick, 542 F.2d 381 (7th Cir. 1976), *cert. denied*, 430 U.S. 931, 97 S. Ct. 1551, 51 L.Ed.2d 775 (1977).

106. Seventh Circuit Pattern Instructions, *supra* note 98, § 6.03; Ninth Circuit Pattern Instructions, *supra* note 98, at 76.

107. United States v. Jones, 735 F.2d 785, 789 (4th Cir.) (emphasis added) (and cases cited therein), *cert. denied*, 469 U.S. 918, 105 S. Ct. 297, 83 L. Ed. 2d 232 (1984).

108. United States v. Illinois Central Railroad Co., 303 U.S. 239, 242-43, 58 S. Ct. 533, 535, 82 L. Ed. 773, 776-777 (1938)

109. For example, tax evasion (26 U.S.C. § 7201 (1989)), making a false tax return (26 U.S.C. § 7206(1) (1989)), and disclosing a false tax return (26 U.S.C. § 7207 (1989))

"willfulness," is that its meaning is not clear.[110] To the extent however, that courts are being admonished to give this instruction less often and are allowed to provide a diluted version of it in at least some cases, the strident version of this instruction may be one less hurdle the government must overcome in proving criminal mens rea.

The erosion of the strongly worded "specific intent" and "willfulness" instructions has been accompanied by increasing usage, at least in white collar criminal cases, of two instructions that make it easier to infer criminal mens rea from recklessness. The "guilty knowledge" instruction,[111] developed in the early 1970s from mens rea definitions in the Model Penal Code (MPC)[112] allows the jury[113] to infer that the defendant had actual knowledge of facts from "proof that a defendant deliberately closed his eyes to what would otherwise have been obvious to him."[114] A common definition of recklessness is "consciously disregard[ing] a substantial and unjustifiable risk."[115] Using this definition,

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all include "willfully" as an element. The "longstanding interpretation" of willfully in these cases is "bad faith or evil intent, . . . evil motive and want of justification in view of all the financial circumstances of the taxpayer." United States v. Bishop, 412 U.S. 346, 360, 93 S. Ct. 2008, 2017, 36 L. Ed. 2d 941, 951 (1973); *see also* United States v. Pomponio, 429 U.S. 10, 12, 97 S. Ct. 22, 23-24, 50 L. Ed. 2d 12, 15-16 (1976).

110. In part, the recommendation of the United States Court of Appeals for the Seventh Circuit not to give this instruction unless specifically included in the offense is because of the inconsistent application of it. Seventh Circuit Pattern Instructions, *supra* note 98, at 85.

111. E. Devitt & C. Blackmar, *supra* note 90, § 14.09; Ninth Circuit Pattern Instructions, *supra* note 98, § 5.07.

112. Model Penal Code § 2.02 (Proposed Official Draft 1962). *See* United States v. Jacobs, 475 F.2d 270, 287 (2d Cir. 1973), *cert. denied sub. nom.* Thaler v. United States, 414 U.S. 821, 94 S. Ct. 116, 38 L. Ed. 2d 53 (1973) for a history of the development of this instruction and cases approving its use.

113. United States v. Picciandra, 788 F.2d 39, 46 (1st Cir.), *cert. denied*, 479 U.S. 847, 107 S. Ct. 166, 93 L. Ed. 2d 104 (1986).

114. E. Devitt & C. Blackmar, *supra* note 90, § 14.09. There are various formulations of this instruction, *see, e.g.*, Ninth Circuit Pattern Instructions, *supra* note 98, § 5.07 ("You may find that the defendant acted knowingly if you find beyond a reasonable doubt that the defendant was aware of a high probability that [the facts relevant to the offense] and deliberately avoided learning the truth."); United States v. Gabriel, 597 F.2d 95, 100 (7th Cir.), *cert. denied*, 444 U.S. 858, 100 S. Ct. 120, 72 L. Ed. 2d 78 (1979) ("Knowledge may be proven by defendant's conduct, and by all the facts and circumstances surrounding the case. No person can intentionally avoid knowledge by closing his eyes to facts which should prompt him to investigate."); United States v. Dozier, 522 F.2d 224, 226 (2d Cir.), *cert. denied*, 423 U.S. 1021, 96 S. Ct. 461, 46 L. Ed. 2d 394 (1975) ("If you find from all the evidence beyond a reasonable doubt . . . that [the defendant] had a conscious purpose to avoid finding out the identity of the substance so as to close her eyes to the facts, you could find sufficient evidence to find her guilty beyond a reasonable doubt.").

115. Model Penal Code § 2.02(2)(c) (Proposed Official Draft 1962). The Model

deliberately closing one's eyes to what would otherwise be obvious is behaving "recklessly." First given in a bank fraud case in 1899,[116] this "guilty knowledge" instruction was not included in the standard criminal jury instructions until the mid-1970s.[117] Since then, its use has increased dramatically, especially in white collar criminal cases.[118] Defendants have opposed this instruction on the ground that it allows a conviction for negligence[119] and for recklessness.[120] The courts have rejected such arguments, reasoning that this instruction merely allows the jury to draw an inference of knowledge from the defendant's "deliberate avoidance" of essential facts.[121]

Significantly, this instruction is not deemed to be appropriate in all criminal cases, but only in cases in which a defendant claims a lack of knowledge of the crime and the facts suggest a conscious course of ignorance.[122] Although this factual predicate will not exist in every criminal case, it will exist in many, if not most, white collar criminal cases.

Penal Code defines recklessly as:

> [C]onsciously disregard[ing] a substantial and unjustifiable risk that the material element [of the offense] exists or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.

Id.

116. Spurr v. United States, 174 U.S. 728, 735, 19 S. Ct. 812, 815, 43 L. Ed. 1150, 1153 (1899).

117. This instruction was not included in the second edition, published in 1970, of E. Devitt & C. Blackmar, Federal Jury Practice and Instructions (2d ed. 1970). By 1977, when the third edition was published, this instruction was included. E. Devitt & C. Blackmar, *supra* note 90, § 14.09. This instruction is based upon United States v. Brawer, 482 F.2d 117, 128-30 (2d Cir. 1973), *on remand*, 367 F. Supp. 156, *appeal after remand*, 496 F.2d 703, *cert. denied*, 419 U.S. 1051, 95 S. Ct. 628, 42 L. Ed. 2d 646 (1974)

118. In Federal Jury Practice and Instructions, Devitt and Blackmar assemble many of the significant citations regarding the jury instructions. A review of the annotations following the "guilty knowledge" instruction reveals that the newer cases are increasingly white collar criminal cases. (*See* "Notes" following Instruction 14.09 in E. Devitt & C. Blackmar, *supra* note 90 (3d ed. 1977 and Supp. 1990).

119. *Massa*, 740 F.2d at 642-43; United States v. Natelli, 527 F.2d 311, 322 (2d Cir. 1975), *cert. denied*, 425 U.S. 934, 96 S. Ct. 1663, 48 L. Ed. 2d 175 (1976).

120. *Cf.* United States v. Evans, 559 F.2d 244, 246 (5th Cir. 1977), *cert. denied*, 434 U.S. 1015, 98 S. Ct. 731, 54 L. Ed. 2d 759 (1978). (The defendant argued that by focusing on reckless disregard, this instruction did not require proof of knowledge. The court rejected Evans' argument.)

121. *See, e.g.,* United States v. Cincotta, 689 F.2d 238, 243 n.2 (1st Cir.), *cert. denied sub nom.* Zero v. United States, 459 U.S. 991, 103 S. Ct. 347, 74 L. Ed. 2d 387 (1982); United States v. Ciampaglia, 628 F.2d 632, 642 (1st Cir.), *cert. denied*, 449 U.S. 956, 101 S. Ct. 365, 66 L. Ed. 2d 221 (1980).

122. *See, e.g.*, *Picciandra*, 788 F.2d at 46; *Ciampaglia*, 628 F.2d at 642-43.

In these cases the criminal acts are usually fully documented in a paper trail, thus a white collar defendant can rarely deny that the alleged conduct occurred. Instead, the more common defense is to claim lack of knowledge. Because white collar criminal cases are often complex and involve voluminous documents and numerous regulations, such a claim of ignorance may be credible even when asserted by proficient business executives. Once a defendant claims such a lack of knowledge he has laid part of the factual predicate for this "guilty knowledge" instruction. Predictably, the government then attempts to prove that if the defendant was as unaware as he claims, he was "deliberately ignorant." This "counter-attack" by the government supplies the remaining factual predicate needed to make this instruction appropriate (facts that suggest a conscious course of ignorance). In this manner, the "guilty knowledge" instruction becomes appropriate in most white collar criminal cases.

The last instruction that demonstrates the trend of according the government greater latitude in proving criminal mens rea is the definition of "false or fraudulent," which is used almost exclusively in white collar criminal cases.[123] This instruction allows the jury to infer criminal mens rea from a defendant's recklessness by defining a "false or fraudulent" representation as "[a] representation . . . known to be untrue, or made with reckless indifference as to its truth or falsity, ..."[124] The "reckless indifference" language was added in the 1970s because, in the words of one court, "reckless indifference for the truth can be fraudulent."[125]

Irwin v. United States[126] demonstrates the applicability of this definition. The defendants, Irwin and Kerns, were indicted on mail fraud charges stemming from allegedly false representations that they made regarding the profitability of franchises they were selling.[127] Kerns argued that Irwin gave him the information in question and that he (Kerns) had no actual knowledge of any falsity in the representations when he repeated them. The Court rejected Kerns' argument and affirmed his conviction stating that at a minimum, "Kerns acted with reckless disregard

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123. This definition is given as part of the instructions for mail fraud, 18 U.S.C. § 1341 (1984 & Supp. 1990). *See* E. Devitt & C. Blackmar, *supra* note 90, § 47.04.

124. E. Devitt & C. Blackmar, *supra* note 90, § 47.04 (Supp. 1990).

125. United States v. Frick, 588 F.2d 531, 536 (5th Cir.,) *cert. denied*, 441 U.S. 913, 99 S. Ct. 2013, 60 L. Ed. 2d 385 (1979). E. Devitt and C. Blackmar indicate that they added "reckless indifference" to the definition of falsity in their second edition of Federal Jury Practice and Instructions, published in 1970. E. Devitt & C. Blackmar, *supra* note 90, at 305 (3d ed. 1977).

126. 338 F.2d 770 (9th Cir. 1964), *cert. denied*, 381 U.S. 911, 85 S. Ct. 1530, 14 L. Ed. 2d 433 (1965).

127. *Id.* at 772.

as to whether the representations he made were true or false."[128] According to the court, "the purpose [of this instruction] is to prevent an individual . . . from circumventing criminal sanctions merely by deliberately closing his eyes to the obvious risk he is engaging in unlawful conduct. . . ."[129] Notably, this instruction has been approved even when the indictment appeared to charge a higher level of mens rea, namely, that the defendant made the allegedly false statements "well knowing" they were false.[130]

In summary, the changes in these four criminal intent instructions reflect a trend toward diluting the government's burden of proving criminal intent. The "specific intent" instruction, with its emphasis on "purposely intending to violate the law," is being phased out. The "willfulness" instruction's reference to "specific intent to do something the law forbids" appears to be fading and is being replaced with a diluted version of "willfully" that equates willfulness with "reckless disregard of the law." Simultaneously, at least in the white collar criminal cases, there is increasing use of the "guilty knowledge" instruction which allows a jury to infer knowledge of facts from evidence that the defendant deliberately closed his eyes to what was obvious. To the extent that deliberately closing one's eyes to the obvious is behaving "recklessly," this instruction arguably allows an inference of criminal mens rea from recklessness. The definition of "false or fraudulent representation" further facilitates inferences of criminal mens rea from recklessness by defining a false or fraudulent representation as one made with reckless disregard for truth or falsity.

Whether the combined effect of these changes in intent instructions improperly reduces the government's burden of proving intent or properly acknowledges the unusual nuances of white collar crimes, is not the subject of this Article. Rather, the relevant issue is the impact these instructions have on permissive indemnification. The typical criminal case is concluded with a simple verdict of guilty or not guilty; no findings of fact are issued that shed additional light on whether or not the defendant meets the standards for permissive indemnification[131] despite her conviction. To assess whether a convicted corporate executive meets these standards, those making the indemnification decision will have to

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128. *Id.* at 774.

129. United States v. Sarantos, 445 F.2d 887, 881 (2d Cir. 1972).

130. *See, e.g.*, United States v. Love, 535 F.2d 1152, 1157-1158 (9th Cir.), *cert. denied*, 429 U.S. 847, 97 S. Ct. 130, 50 L. Ed. 2d 119 (1976).

131. Generally, the only time in which specific findings of fact are issued in a criminal case is after a bench trial when the court lists its specific findings. Even in this situation, the written findings may not directly address the exact inquiry necessary to assess an executive's qualification for indemnification.

look beyond the simple verdict to the charges, to the evidence and to the applicable law on mens rea. When these individuals do so and observe a strict liability offense or the use of jury instructions that allow an inference of criminal mens rea from recklessness, it is possible, perhaps inevitable, that they will determine that the convicted executive meets all qualifications for permissive indemnification. Moreover, such a determination is even more likely if those making it are sympathetic to the executive seeking indemnification. This potential sympathy leads to the next issue — the procedure for authorizing permissive indemnification.

b. Procedure for authorizing permissive indemnification

All but four states[132] provide that at least the following three types of individuals can authorize indemnification: directors who were not parties to the proceeding in question,[133] legal counsel, and shareholders.[134]

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132. Neither Massachusetts' nor Vermont's incorporation statutes specify the procedure for authorizing indemnification. Mass. Gen Laws Ann. ch. 156B, § 67 (West 1970 & Supp. 1990); Vt. Stat. Ann. tit. 11, § 1852(15) (1984). Utah provides for only two of the three authorizing options provided in the other statutes. Utah Code Ann. § 16-10-4(d) (1987 & Supp. 1990). California does not include legal counsel as an authorizing official. Its statute provides that directors, shareholders, or the court before whom the proceeding is pending may authorize the indemnification. Cal. Corp. Code § 317(e) (West 1977 and Supp. 1990).

133. Twenty state statutes provide another mechanism by which a committee of at least two directors who are not parties to the proceeding in question but are chosen by the other directors, including those who are or were parties, may authorize indemnification. This committee is appointed only if a quorum of directors who were not parties to the action suit or proceeding is unavailable. The RMBCA's provision, followed by all twenty states, provides:

> [I]f a quorum cannot be obtained . . ., by majority vote of a committee duly designated by the board of directors (in which designation directors who are parties may participate), consisting solely of two or more directors not at the time parties to the proceeding . . . . [may authorize indemnification].

RMBCA § 8.55(b)(2) (1984). The States including this option are Florida, Georgia, Indiana, Kentucky, Maryland, Michigan, Minnesota, Mississippi, Montana, New Mexico, North Carolina, North Dakota, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Virginia, Washington, and Wyoming. *See supra* note 11 for statutory citations.

134. The Delaware statute provides typical phrasing of these options:

> Any indemnification [under this chapter and unless ordered by a court] shall be made by the corporation only as authorized in the specific case upon a determination that indemnification . . . is proper in the circumstances because he has met the applicable standard of conduct [set forth in the statute]. Such determination shall be made (1) by the board of directors by a majority vote of a quorum, consisting of directors who were not parties to such action, suit or proceeding, or (2) if such a quorum is not obtainable, or, even if obtainable a quorum of disinterested directors so directs, by independent legal counsel in

Seven state codes also provide that the court before whom the proceeding is pending may authorize indemnification.[135]

If directors are to determine the propriety of allowing permissive indemnification, most statutes require that there be a majority vote of a quorum of directors who were not parties in the proceedings. It is questionable whether it is humanly possible, even for directors not involved in the proceedings, to be objective in authorizing indemnification for one of their peers. Not only are these directors likely to be friends and colleagues of those seeking indemnification,[136] but they may believe it to be in their self-interest to create a favorable precedent of generous indemnification.

Designating legal counsel as an authorizing official when disinterested directors are not available does not avoid the possibility of bias. Admittedly the indemnification statutes specify that legal counsel should be "independent"[137] or "special," but beyond this very general ad-

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> a written opinion, or (3) by the stockholders.

DEL. CODE ANN. § 145(d) (1983 & Supp. 1988).

It should be noted that there are a few additional variations to the three-part option generally provided. Alabama provides that the directors authorizing indemnification cannot be parties to the proceeding or parties who "have been 'wholly successful on the merits or otherwise' with respect to . . . such claim, action, suit or proceeding . . . ." ALA. CODE § 10-2A-21(d)(1) (1987). Connecticut provides that if the executive seeking indemnification is an employee or agent who is not an officer or director of the corporation, the corporation's general counsel may authorize the indemnification. CONN. GEN. STAT. ANN. § 33-320a(d)(3) (West 1987). Wisconsin provides the following option:

> [A] panel of 3 arbitrators consisting of one arbitrator selected by [disinterested directors], one arbitrator selected by the director or officer seeking indemnification and one arbitrator selected by the 2 arbitrators previously selected.

WIS. STAT. ANN. § 180.046(3) (West Supp. 1990).

135. California's provision is typical:

> [I]ndemnification . . . shall be made by the corporation . . . upon a determination that . . . the [executive seeking indemnification] has met the applicable standard of conduct set forth in [the statute] by . . . [t]he court in which such proceeding is or was pending . . . .

CAL. CORP. CODE § 317(e) (West 1977 & Supp. 1990). The other states allowing some version of this option are Arizona, Colorado, Hawaii, Minnesota, North Dakota, and Ohio. *See supra* note 11 for statutory citations.

136. Herman, CORPORATE CONTROL, CORPORATE POWER 194-195 (1981); Modic, *CEOs Prefer CEOs*, INDUSTRY WK 28 (May 2, 1988); *cf.* Arnold & O'Callaghan, *The New Board of Directors: A Survey of Canadian Chief Executive Officer's*, BUS. Q. 77, 79 (Summer 1988) (One CEO of a Canadian financial institution stated, "There are about 250 experienced Canadian directors and on this small group falls all of the demands for board skill and constituency representation.").

137. The following twenty-eight states declare that the counsel making this determination must be "independent legal counsel: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Kansas, Louisiana, Maine, Michigan, Nebraska, Nevada, New Hampshire, New York, Ohio, Okla-

monition all but two of the indemnification statutes are silent.[138] Ohio specifies that the "independent legal counsel" shall be "other than an attorney, or a firm having associated with it an attorney, who has been retained by or who has performed services for the corporation or any person to be indemnified within the past five years."[139] Minnesota's provision also refers to past contact with the corporation or its executives. It provides that "special legal counsel" is "counsel who has not represented the corporation or [a person] whose indemnification is in issue."[140] While commendable, these restrictions are still too narrow. They focus only on past relationships to a corporation or its executives; they fail to acknowledge the temptation of future business. In almost every instance,[141] directors choose the attorney who is to make the indemnification determination. Even the most noble attorneys among us would have difficulty resisting the lure of new corporate business by failing to satisfy the directors who retained our services. When it is apparent that these directors believe indemnification is proper, one suspects that few attorneys, however "independent" or "special," would disallow indemnification.[142]

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homa, Pennsylvania, South Dakota, Tennessee, West Virginia, Wisconsin. *See supra* note 11 for statutory citations.

138. The following eighteen states declare that counsel must be "special legal counsel": Georgia, Indiana, Iowa, Kentucky, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Carolina, North Dakota, Oregon, Rhode Island, South Carolina, Texas, Washington, Wyoming, Virginia. *See supra* note 11 for statutory citations.

Although the provisions for the RMBCA do not elaborate on what is meant by "special legal counsel" the comments to § 8.55 provide that "'special legal counsel' should normally be counsel having no prior professional relationship with those seeking indemnification, should be retained for the specific occasion, and should not be either inside counsel or regular outside counsel." RMBCA Official Comments to § 8.55, 2 Model Business Corp. Act Ann., *supra* note 58, at 1130.

To the extent this comment addresses more than past relationships, it is an improvement over both the Ohio and Minnesota statutory explanations, (*see infra* text accompanying notes 139 and 140) but because this restriction is in the comment, rather than the statute itself, it is not as binding on courts as if it was part of the statute. Moreover, its reference to bias from present or future business is quite narrow and attorneys other than "inside counsel or regular outside counsel" may succumb, again even subconsciously, to the lure of new business. Lastly, this entire admonition may be neutralized by the next sentence in the comments: "It is important that the selection process be sufficiently flexible to permit selection of counsel in light of the particular circumstances and so that unnecessary expense may be avoided." *Id.*

139. Ohio Rev. Code Ann. 1701.13(E)(4)(b) (Baldwin 1986 & Supp. 1990).

140. Minn. Stat. Ann. § 302A.521 subd. 1(e) (West 1985 & Supp. 1990).

141. The incorporation statutes of forty states (all states except Alabama, Alaska, California, Hawaii, Massachusetts, Nebraska, New Hampshire, Utah, and Vermont) specifically state that the directors may choose the "independent" or "special" legal counsel who is to make the indemnification decision. *See supra* note 11 for statutory citations.

142. Bishop refers to the "uncertainty" in the "independence" of "independent

c. The exclusivity provision

It is with the exclusivity provision that the "patchwork"[143] nature of corporate indemnification begins to become apparent. Even if directors, legal counsel, shareholders or a court determine that a convicted executive does not qualify for indemnification pursuant to the statutory standards for mandatory and permissive indemnification, all is not lost for the convicted executive. In the jurisdictions governed by a nonexclusive statute, the corporation may still indemnify the convicted executive pursuant to bylaws, corporate resolutions, or contracts negotiated with the executive. Moreover, none of these options must comply with the restrictions for indemnification set forth in the statute. Almost three-fifths of the states have followed Delaware's lead of opting for the most expansive indemnification possible by passing the following provision: "The indemnification authorized by this [statute] shall not be exclusive of, and shall be in addition to, any other rights granted to those seeking indemnification under the articles or regulations or any agreement, vote of shareholders or disinterested directors, or otherwise. . . ."[144] As noted, only two states, Minnesota and North Dakota, have limited the power of corporations to grant indemnification that exceeds the restrictions in the statute.[145]

The RMBCA has pioneered an approach on indemnification that has been followed in nine states.[146] In 1980 the RMBCA amended its exclusivity provision by substituting its broad, Delaware-like statement[147]

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legal counsel":

> No one need question the honesty of these darlings of corporate draftsmen: the problem rather is that those who choose them are pretty sure to favor a lawyer who has acquired in the course of a corporate practice a sympathetic understanding of the problems of corporate management. It is not easy for even a lawyer of the most rugged integrity to be harsh to people who were responsible for his retainer. But in fact counsel may well be a regular associate and friend of the defendants: "independent" may turn out to mean nothing more than he is not an employee of the corporation.

Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1079-80.

143. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 WIS. L. REV. at 517 (referring to indemnification of directors and officers, in general, as "a patchwork of state corporation and insurance codes, court and agency interpretations of various federal securities statutes, and federal and state doctrines of contractual waiver.")

144. *See supra* note 25.

145. *See supra* note 26.

146. *See supra* notes 28-30 and accompanying text.

147. The Model Business Corporation Act provides as follows:

> The indemnification provided by this section shall not be deemed exclusive of any other rights to which those indemnified may be entitled under any by-law, agreement, vote of shareholders or disinterested directors.

§ 5(f) (1971).

on nonexclusivity for a provision that allows corporations to indemnify directors outside the statute "only if and to the extent [such] provision is consistent with this subchapter."[148] Under the RMBCA, therefore, corporations may still indemnify convicted directors outside the statute if such indemnification is "consistent with" the statutory requirements for indemnification. Indemnification will be "consistent with" the statute if the executive is found to have acted "in good faith," with the reasonable belief "that his conduct was in the best interests of the corporation,"[149] and with "no reasonable cause to believe his conduct was unlawful."

The Official Comments to the RMBCA explain that this change was made to more accurately reflect the fact that "nonstatutory conceptions of public policy limit the power of a corporation to indemnify or to contract to indemnify directors, officers, employees or agents."[150] Although it is encouraging to see attention given to public policy as a restriction on indemnification, there are two major problems with the RMBCA revision, in the context of criminal convictions. First, it is not clear how this provision applies to the criminally convicted executive. The Official Comments explain that "[i]t is important to recognize that 'to the extent it is consistent with' is not synonymous with 'exclusive.'"[151] If the "consistent with" language is meant to establish a minimum limit, prohibiting corporations from adopting indemnification policies less generous than the RMBCA, this language is fairly clear and most likely prevents corporations from executing bylaws, resolutions, or contracts that categorically disallow indemnification for executives convicted of criminal offenses. Such a bylaw, resolution or contract would be less generous than the statute since, as we have seen, both the standards and procedures for allowing permissive indemnification leave plenty of room for a convicted executive to qualify for indemnification.

However, to the extent the "consistent with" language establishes a maximum limit prohibiting corporations from adopting an indemnification policy that exceeds the indemnification in the statute, the meaning of this provision becomes murky. Although the Comments state that there are "situations" that "may well develop . . . in which indemnification is permissible under [the consistent with provision] but would be precluded if all portions of [the indemnification statute] were viewed

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148. *See supra* note 30 for the full text of this statutory provision and its comparison to a similar provision regarding corporative executives who are not directors.

149. RMBCA § 8.51 (1984).

150. RMBCA Official Comments to § 8.58, 2 Model Business Corp. Act Ann., *supra* note 58, at 1139.

151. *Id.*

as exclusive,"[152] it is difficult to imagine any criminal situations that would so qualify without substantial skill at doublespeak. If a convicted executive cannot meet the standards of the RMBCA for indemnification (i.e., the mandatory or permissive standards) and thus the statute precludes indemnification to him, it is hard to see how this executive could still qualify for indemnification under any circumstance that is still consistent with the RMBCA's standards. The confusion is compounded by section 8.54(2) of the RMBCA which allows a court to grant indemnification if a director is "fairly and reasonably entitled to indemnification in view of all relevant circumstances," even though the director may not have met the mandatory or permissive standards.[153] If the "consistent with" requirement of section 8.58 governs all provisions of the indemnification subchapter, including section 8.54(2), it would appear that court-ordered indemnification to an executive who cannot meet the statutory standards is not "consistent with" the RMBCA, regardless of how "fair and reasonable" indemnification may seem. On the other hand, if section 8.58 is inapplicable to section 8.54(2) and a court is not obliged to order only indemnification that is consistent with the RMBCA, then the RMBCA ends up being nonexclusive, but only when a court, rather than the corporation, exceeds the statute. If this latter interpretation of the "consistent with" language in section 8.58 is correct and if the executive can find a court that believes indemnification to him is "fair and reasonable," section 8.54(2) provides a small window of opportunity for the convicted executive who fails to meet the RMBCA's statutory standards to obtain indemnification.

Looking further for the possible meaning of the "consistent with" language in the context of criminal convictions, it is possible that the "consistency" requirement pertains only to procedural matters rather than to substantive consistency with the mandatory and permissible standards. The Official Comments lend support to this view. They state that the consistency requirement "does not preclude provisions in articles of incorporation, by-laws, resolutions, or contracts designed to provide procedural machinery different from that [in the statute]."[154] This tautology tells us little, for unless the procedure is identical to that in the statute, it is by definition different. The real question is how different the procedure may be and still be "consistent with" the RMBCA. For example, the RMBCA requires that the directors who authorize the indemnification must be a majority of a quorum of directors who were

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152. RMBCA Official Comments to § 8.58, 2 Model Business Corp. Act Ann., *supra* note 58, at 1139.

153. RMBCA § 8.54(2) (1984).

154. RMBCA Official Comments to § 8.58, 2 Model Business Corp. Act Ann., *supra* note 58, at 1140.

not parties to the proceeding in question. One wonders: is it "consistent with" the RMBCA if less than a majority of disinterested directors authorize indemnification? Or, is it sufficient if the authorizing directors are the individuals seeking indemnification? One would think that neither of these procedural deviations would be allowed, but neither the exclusivity provision itself nor the Comments provide guidance.

If, in fact, the RMBCA drafters simply intended for the "consistent with" language to highlight the fact that principles of public policy restrict any indemnification, it seems that the following provision, adopted by the RMBCA for officers, is more to the point:

> A corporation may also indemnify and advance expenses. . . .to the extent, *consistent with public policy*, that may be provided by its articles of incorporation, bylaws, general or specific action of its board of directors, or contract.[155]

In addition to its lack of clarity, the other major problem with the RMBCA's exclusivity provision is that it erroneously assumes that principles of public policy, as applied by the courts, are an effective limitation on indemnification. Such an assumption is questionable for two reasons. First, courts may not get the opportunity to exercise supervision over indemnification awards. The primary mechanism for challenging the propriety of a particular indemnification award in the courts is a shareholder derivative suit alleging that use of corporate assets to pay such indemnification is improper.[156] However, if the shareholders do not know of the indemnification they cannot challenge it. As discussed infra,[157] under current indemnification statutes and practices, shareholders usually do not know when a corporation has indemnified its executives, even when those executives have been convicted of crimes. The second reason that the courts' application of principles of public policy is an ineffective check on improper indemnification is that the courts' interpretation and application of these principles has been erratic.[158]

The idea that public policy considerations should limit a corporation's power to indemnify directors and officers grew out of insurance law.[159]

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155. RMBCA § 8.56(3) (1984) (emphasis supplied).

156. Note, *Insurance for Executives*, *supra* note 8, 80 HARV. L. REV. at 667-68 and 665.

157. *See infra* notes 216-20 and accompanying text.

158. *See, e.g.*, Johnston, *Indemnification and Insurance*, *supra* note 8, 33 BUS. LAW. at 2024-29 (discussing the inconsistent way courts have applied principles of public policy regarding insurance coverage for intentional acts).

159. McNeely, *Illegality As A Factor in Liability Insurance*, 41 COLUM. L. REV. 26 (1941). "Throughout its history the insurance device has been alternately hailed as a promoter of communal welfare and damned as a generator of evil." *Id.* This fascinating

As early as 1837, courts refused to allow insurance coverage for willful acts.[160] However, the courts' transference of this principle of insurance law to corporate indemnification has been inconsistent. Some courts strictly maintain that such indemnification for willful acts is against public policy. *Globus v. Law Research Service, Inc.*[161] demonstrates this approach. Noting that one cannot insure himself against his own reckless, willful, or criminal misconduct,"[162] the United States Court of Appeals for the Second Circuit held that "it would be against the public policy"[163] to allow a party who had actual knowledge of material misstatements to receive corporate indemnification.[164] *Associated Milk Producers, Inc. (AMPI) v. Parr*[165] further demonstrates the application of this principle in the criminal context. Parr, an officer of AMPI, sought indemnification from AMPI for $12,500.00 in criminal fines and $36,620.60 in legal fees and expenses which he incurred in unsuccessfully defending himself against federal conspiracy bribery charges.[166] Parr argued that he qualified for indemnification under an AMPI bylaw that required indemnification for "any loss for any matters performed for or on behalf of the Association in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the Association."[167] The court found that Parr genuinely believed that the political contributions at issue were "in the best interest of AMPI or at least not opposed to these interests" and that the officers and at least some directors of AMPI shared this belief. However, the court refused to find that Parr

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article chronicles several striking examples of this fact, to wit, life insurance was originally banned in many countries "as gambling on lives and encouraging murders," and fire insurance was condemned because it "was a temptation to commit arson or, at the least, to speculate." *Id.*

For sources discussing the common law rule that indemnification and insurance are not available for fraudulent or willful misconduct, see Johnston, *Indemnification and Insurance*, *supra* note 8, 33 Bus. Law at 2006; Note, *Indemnification of Directors*, *supra* note 4, 76 Harv. L. Rev. at 1414-15.

160. Waters v. Merchants Louisville Ins. Co., 11 Pet. 213 (U.S. 1837); *see, e.g.*, Couch, 9 Couch on Insurance § 39:15 (2d ed. 1985); 1B Appleman, Insurance Law & Practice § 451 (1981).

161. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913, 90 S. Ct. 913, 25 L. Ed. 2d 93 (1970).

162. *Id.* at 1288.

163. *Id.* (quoting the trial court decision in this case, Globus v. Law Research Service, Inc., 287 F. Supp. 188, 199 (S.D.N.Y. 1968)).

164. For other cases taking this position, *see, e.g.*, Odette v. Shearson, Hammill & Co., 387 F. Supp. 163, 168 (D. Del. 1974); Gould v. American-Hawaiian Steamship Co., 394 F. Supp. 946, 957 (S.D.N.Y. 1975).

165. 528 F. Supp. 7 (E.D. Ark. 1979).

166. *Id.* at 7-8.

167. *Id.* at 7.

acted in "good faith" because he "deliberately violate[d] federal criminal law" and, by definition, "such conduct cannot be 'in good faith.'"[168]

Most of the courts that have applied principles of public policy and disallowed indemnification for intentional, reckless or criminal acts have focused on the deterrent effect of the statutes violated by those seeking indemnification.[169] Commentators who oppose indemnification for such acts have focused on the need for deterrence,[170] as well as on the damage such indemnification does to our system of justice[171] and to a viable system of insurance.[172]

Other courts, while acknowledging the importance of these public policy concerns, find that they are outweighed by competing public interests such as the need to attract qualified executives. Indemnification grew out of the belief that the promise of such reimbursement was necessary if corporations were to attract qualified corporate executives.[173] And, in fact, as the risk of liability to executives has increased in recent years, courts, legislatures, and commentators have responded by expanding the rights to indemnification.[174] The opinion of the United States Court of Appeals for the Third Circuit in *Mooney v. Willys-Overland Motors, Inc.*[175] is an often cited example of a court that allowed in-

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168. *Id.* at 8.

169. *See, e.g.*, *Odette*, 394 F. Supp. at 954 ("Indemnification in such circumstances ["involving actual knowledge of false and misleading statements or omissions and wanton indifference to its obligations . . ."] would reduce the deterrent effect of the securities laws, and [is] therefore against public policy."). Interestingly, the *Odette* court continued to hold that, for the same reason, indemnification where reckless disregard is shown is also against public policy. *Id.* at 955. *See also Gould*, 387 F. Supp. at 168 ("To allow indemnity to those who have breached responsibilities squarely placed upon them by the statute would vitiate the remedial purposes of § 14(a) [of The Securities Act of 1934 prohibiting misstatements in proxy solicitations]. Only a realistic possibility of liability for damages will encourage due diligence by those who solicit proxies and will protect the interest of informed corporate suffrage.").

170. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 Wis. L. Rev. at 514, 532 and 582; Coffee, *No Soul to Damn*, *supra* note 8, 79 Mich. L. Rev. at 407-11; Note, *Insurance for Executives*, *supra* note 8, 80 Harv. L. Rev. at 655; *cf.* Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1087 (arguing that indemnification to executives found to have committed deliberate misfeasance and held civilly liable is not appropriate when the purpose of the civil liability is deterrence.)

171. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 Wis. L. Rev. at 535, 577-78; Stone, *Enterprise Liability*, *supra* note 8, 90 Yale L.J. at 55.

172. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 Wis. L. Rev. at 523; Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1088; Note, *Insurance for Executives*, *supra* note 8, 80 Harv. L. Rev. at 655.

173. *Mooney*, 204 F.2d at 898; *Merritt-Chapman*, 321 A.2d at 141; RMBCA, Introductory Comment to Subchapter E (Indemnification), 2 Model Business Corp. Act Ann., *supra* note 58, at 1081.

174. *See supra* notes 18-23 and accompanying text.

175. 204 F.2d 888 (3d Cir. 1953).

demnification for this reason. In affirming indemnification to the former president and director of Willys-Overland for costs incurred in civil litigation, the court noted that the purpose of indemnification "is to encourage capable men to serve as corporate directors."[176] The Third Circuit's approach finds support in other types of insurance cases. In *Colson v. Lloyd's of London*,[177] the Missouri Court of Appeals held that Lloyd's liability policy covered compensatory and punitive damages assessed against the insured, a sheriff, for false arrest.[178] Lloyd's argued that coverage of punitive damages, which are imposed for "wanton, reckless, or willful acts would be contrary to public policy."[179] The court rejected Lloyd's argument, noting that qualified persons may be discouraged from entering law enforcement if such coverage is not provided.[180]

Indemnification for attorneys fees raises the additional public policy concern of providing counsel to those accused of crimes. For example, Lloyd's lost again in *Flintkote Co. v. Lloyd's Underwriters*[181] when it argued against the insurability of attorneys fees incurred by an executive convicted on antitrust charges. Lloyd's argued that because such fees were incurred after a finding of guilt in a criminal matter, it was against public policy to insure them. The court disagreed, finding that public policy was served by having counsel available to represent the Flintkote's executive.[182] *Little v. MGIC Indemnity Corp.*[183] provides another example of this particular balancing of competing policy concerns. At issue in *Little* was whether a D&O insurance policy obligated the insurer to pay legal fees as those fees were incurred by Little, a bank officer named as defendant in five civil actions alleging that he committed fraud.[184] Finding that the pertinent policy language was ambiguous, the court resolved the ambiguity against the insurer and ordered the insurer to advance the costs of attorney fees.[185] Significantly, the court also held that even if the policy language did not obligate the insurer to pay the attorneys fees as those fees were incurred, holding otherwise "would be unconscionable" because the directors and officers "would be forced to

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176. *Id.* at 898.
177. 435 S.W.2d 42 (Mo. Ct. App. 1968).
178. *Id.* at 43, 47.
179. *Id.* at 47.
180. *Id.*
181. 176 N.Y.L.J., July 27, 1976, at 6 (N.Y. Sup. Ct.), *aff'd*, 56 A.D.2d 743, 391 N.Y.S.2d 1005 (1977).
182. *Id.*
183. 649 F. Supp. 1460 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).
184. *Id.* at 1462.
185. *Id.* at 1466-68.

advance all their defense expenditures, which are likely to be staggering."[186]

Still other courts have simply disregarded public policy concerns and allowed full indemnification to convicted corporate executives without discussion of any public policy rationales. *Choate, Hall, Stewart v. SCA Services, Inc.*[187] provides an example. In this case the Massachusetts Court of Appeals explicitly noted that "an agreement to indemnify . . . must be able to withstand an attack on grounds of policy or basic equity."[188] Yet, the court held that an SCA director who pled guilty to securities fraud was, nevertheless, properly indemnified.[189] Apparently disregarding the fact that the director was now a convicted criminal, the court stated that there was no evidence that the director "intentionally or willfully violated any fiduciary duty owed to SCA" or "aided or abetted in any wrongdoing."[190] The court never addressed the question of whether or how public policy was served by indemnifying a criminal.

Koster v. Warren[191] provides another example of apparent disregard of the significance of a criminal conviction. Safeway shareholders brought a derivative suit challenging Safeway's $75,000 indemnification to a former officer for fines the officer paid after being convicted on antitrust charges.[192] The shareholder suit alleged that this indemnification was a waste of corporate assets and a breach of the fiduciary obligation owed to the shareholders.[193] The court never addressed any issue of public policy, analyzing the case instead as a simple matter of contract law. It found that because the executive changed his plea from "not guilty" to "nolo contendere," Safeway received consideration in return for its payment of the executive's fine.[194] Without explanation, this court apparently considered full indemnification to be proper reciprocal consideration for the switch to the nolo contendere plea. Similarly, in *Simon v. Socony-Vacuum Oil Co.*,[195] the Supreme Court of New York held that the Socony-Vacuum Oil Company properly paid defense costs and fines incurred by directors who were convicted of antitrust violations because, by the directors' plea of nolo contendere, "valuable consideration moved from the [directors] to the corporation, and the corporation

186. *Id.* at 1468.

187. 22 Mass. App. Ct. 522, 495 N.E.2d 562 (1986).

188. *Id.* at 529, 495 N.E.2d at 566.

189. *Id.* at 529-32, 495 N.E.2d at 567-68.

190. *Id.* at 531, 495 N.E.2d at 567.

191. 176 F. Supp. 459 (N.D. Cal. 1959), *aff'd*, 297 F.2d 418 (9th Cir. 1961).

192. *Id.* at 460.

193. *Id.*

194. *Id.* at 461-62.

195. 179 Misc. 202, 38 N.Y.S.2d 270 (N.Y. Sup. Ct. 1942), *aff'd*, 267 A.D. 890, 47 N.Y.S.2d 589 (1944).

clearly benefited thereby."[196] There was no mention or discussion of whether public policy was served by such indemnification.[197]

Without a doubt the courts' application of public policy to reimbursement of convicted executives, whether by corporations or insurers, is erratic. Some courts aggressively disallow indemnification of convicted executives on the ground that such indemnification threatens the public interest. Other courts are just as likely to find that the public's interest is better served by allowing indemnification because it helps corporations attract talented executives and, when the need arises, assures that they have an effective defense. Still other courts order indemnification to convicted executives without addressing any of the public policy concerns presented by the executive's criminal liability.

To conclude: The nonexclusivity provision in most incorporation statutes allows the greatest opportunity for full indemnification of convicted executives by permitting corporations to indemnify their convicted executives even when it is clear that these executives do not meet the statutory standards for indemnification. The only limitation on such indemnification is that which may be imposed by the courts as they apply common law notions of public policy. Because the courts so erratically apply these principles of law, however, their oversight is not an effective or reliable check on inappropriate indemnification of corporate executives. It is significant to note that the recent trend in state incorporation statutes is toward broader nonexclusivity provisions.[198] Al-

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196. *Id.* at 206, 38 N.Y.S.2d at 275.

197. *Id.* at 205-06, 38 N.Y.S.2d at 274-75. Note, *Indemnification of Directors*, *supra* note 4, 76 Harv. L. Rev. at 1425-26 (attacking the reasoning of Simon v. Socony-Vacuum Oil Co. and Koster v. Warren for utilizing the "conceptual nicety" of contract analysis while ignoring the policy problem posed when indemnification negates the "punitive sanction which the federal government has determined to impose").

This approach may have developed from insurance law. There are examples of courts holding that insurance is available for "willful and felonious" action. For example, in New Amsterdam Casualty Co. v. Jones, 135 F.2d 191 (1943), the United States Court of Appeals for the Sixth Circuit held that insurance covered a willful and felonious assault inflicted by the insured. The court addressed the argument that it is against public policy to insure against one's own intentional, illegal acts, *id.* at 193, but noted that "[p]ublic policy is a changing concept," *id.* at 194. The court found that the prospect that insurance would cover any judgment obtained for an assault was a "vague possibility of benefit" and insufficient to void the insurance contract. *Id.* at 195.

198. For example, until recently, New York and New Mexico used the RMBCA approach on the exclusivity issue, that is, indemnification outside the statute was permitted as long as it was "consistent with" the indemnification provided in the incorporation statute. N.Y. Bus. Corp. Law § 721 (McKinney 1986) (repealed 1986); N.M. Stat. Ann. § 53-11-4.1(G) (1983) (repealed 1983).

Now, both statutes use the broader (and clearer) rule that indemnification authorized by the statute shall not be deemed exclusive of any other rights under the articles of

though the RMBCA represents a rejection of this trend, because of its vagueness and its similar reliance on the largely erratic notions of public policy, it too, fails to serve as an effective limit on corporations' unbridled power to indemnify.

d. Advancing expenses

Even if it becomes clear after an executive has been convicted that he is ineligible for indemnification, it may be too late to deny him indemnification because he has already received it in the form of "advances" to cover the attorneys fees and other costs he has incurred. Forty-nine states explicitly grant corporations the power to advance attorney fees before there has been a judgment of guilt or innocence.[199]

Granting advances is not necessarily a problem; the practice becomes a problem only when an advance is not recovered from an executive who ultimately is determined to be ineligible for indemnification. How often this occurs depends upon the corporation's initiative in recovering advanced funds after it becomes clear that the executive does not qualify for indemnification. The incorporation statutes impose no meaningful requirement or mechanism for reclaiming such advances and without a statutory requirement, it is questionable how aggressively corporations will seek repayment. This is especially true given the secrecy in which the advances were likely made and the friendly relationship that may exist between the convicted executive and his corporate colleagues who must seek repayment.

Twenty-three states follow the Delaware approach on advances,[200] which requires no assessment, prior to granting the advance, of whether

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incorporation, the bylaws, an agreement, a resolution of shareholders or directors. N.Y. Bus. Corp. Law § 721 (McKinney Supp. 1990); N.M. Stat. Ann. § 53-11-4.1(G) (Supp. 1989).

In addition, other states which have adopted other indemnification provisions of the RMBCA have rejected its "consistent with" language in favor of the "shall not be deemed exclusive" language of the Delaware statute. *See, e.g.*, Ind. Code Ann. § 23-1-37-15 (West 1989). *See also id.* (Official Comments); Va. Code Ann. § 13.1-704 (1989).

199. Vermont's incorporation statute does not explicitly authorize corporations to pay defenses as incurred. Vt. Stat. Ann. tit. 11, § 1852(15) (1984).

200. Alabama, Arizona, Arkansas, California, Florida, Hawaii, Idaho, Illinois, Kansas, Louisiana, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Dakota, Utah, and West Virginia all follow the Delaware approach. *See supra* note 11 for statutory citations.

As noted, *supra* note 30, (regarding exclusivity of statutes), some incorporation statutes apply different standards to different categories of corporate executives. Advancement-of-fees is one instance when this occurs. Delaware, Florida, Kansas, Oklahoma, and South Dakota, for example, all provide that advancement of fees *to a director or officer* is permissible upon an undertaking to repay if the director or officer is ultimately found

the executive appears able to ultimately meet the standard for permissive indemnification. Moreover, the Delaware approach provides little assurance of repayment since it allows a corporation to advance funds to an executive simply upon an "undertaking by or on behalf of [the executive] to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified."[201] Because there is no explicit requirement that this undertaking be secured, it may be meaningless; as one draftsman of the Delaware statute opined, this undertaking is simply an agreement to repay.[202] The RMBCA makes it even more clear that security is not part of this undertaking to repay: it specifies that the undertaking "need not be secured and may be accepted without reference to financial ability to make repayment."[203] The Official Comments to the RMBCA explain that this is so "wealthy directors [will] not be favored over directors whose financial resources are modest."[204]

Admittedly, the RMBCA imposes two requirements additional to the undertaking to repay which must be met by the executive or the corporation before the corporation may advance funds.[205] Both requirements make an effort to assess the executive's ultimate ability to meet the statutory standards for indemnification but they fail to effectively do so. The first requirement is that an executive seeking an advance of funds for expenses must furnish the corporation with a written affirmation of her good faith belief that she has met the standard for indemnification.[206] The problem is that one cannot expect an executive to admit

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ineligible for indemnification, but that advancement of fees *to other employees and agents* may be "so paid upon such terms and conditions, if any, as the board of directors deems appropriate." *See supra* note 11 for statutory citations.

201. The Delaware provision provides in full as follows:

> Expenses incurred by an officer or director in defending a civil or criminal action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it ultimately be determined that he is not entitled to be indemnified by the corporation as authorized in this Section. Such expenses incurred by other employees and agents may be so paid upon such terms and conditions, if any, as the board of directors deems appropriate.

DEL. CODE ANN. tit. 8, § 145(e) (1983 & Supp. 1988).

202. Professor Ernest L. Folk, *quoted in* Comment, *Law For Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 883 (1969).

203. RMBCA § 8.53(b) (1984).

204. RMBCA Official Comments § 8.53, 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 58.

205. RMBCA § 8.53(a) (1984).

206. The following states follow the RMBCA in imposing this requirement: Alaska, Colorado, Georgia, Indiana, Kentucky, Iowa, Maine, Maryland, Michigan, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, Rhode Island, South Carolina,

anything but good faith, certainly in the early stages of a criminal proceeding. As such, this requirement provides little assurance that an undeserving executive will fail to qualify for advances. The second requirement is that the advance of funds must be preceded by a determination "that the facts then known to those making the determination would not preclude indemnification."[207] This requirement has more potential to be a viable check on improper advances than does the affirmation of good faith requirement, but it is still inadequate. Its weakness lies in its reliance upon other provisions in the indemnification statutory scheme that also ineffectively control improper indemnification. For example, in determining whether facts "then known" preclude indemnification, the parties must apply the statutory standard for permissive indemnification. As noted, because these standards are too broad, they improperly allow indemnification to convicted executives.[208] Also, the individuals making this preliminary "determination" will be those officials eligible to make the final indemnification decision. As noted, because of the interests and loyalties of these officials, they may well be inappropriately biased toward the convicted executive.[209]

Another problem with this fact-finding obligation is the difficulty of fulfilling it. Conceivably, to fully inform oneself of the facts "then known" could take as long as the criminal investigation itself, thereby depriving the executive of any advance. To undertake no investigation and truly rely on facts "then known" is perilous when the fact-finder knows very little; shareholder derivative actions may later challenge whether the fact-finder's reliance on facts "then known" met the requisite duty of care. This predicament points to a deeper truth: The fact-finders

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Tennessee, Texas, Virginia, Washington, Wisconsin, and Wyoming. (Washington makes this requirement an alternative to a determination "that the facts then known to those making the determination would not preclude indemnification.") *See supra* note 11 for statutory citations.

207. The following states also impose this requirement: Alaska, Colorado, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, Mississippi, Montana, New Mexico, New York, North Dakota, Rhode Island, South Carolina, Tennessee, Virginia, Washington, and Wyoming. (Washington imposes this requirement as an alternative to the requirement of the executive's affirmation of good faith.) Interestingly, six states (Georgia, Iowa, Maryland, Oregon, Texas, and Wisconsin) that followed the RMBCA in imposing the requirement of an affirmation of good faith belief in qualification for indemnification, declined to also impose this requirement which is found in the RMBCA. The Comment accompanying the Georgia Code explained that it rejected this additional requirement "[b]ecause all of the board are frequently named defendants, [therefore] such a determination would involve a conflict of interests, and implementation of . . . costly procedures . . . ." Official Comment to GA. CODE ANN. § 14-2-853 (1989).

208. *See supra* notes 55-131 and accompanying text.

209. *See supra* notes 132-42 and accompanying text.

who have been given the responsibility of making a preliminary determination of eligibility for indemnification may have an impossible mission. In the early stages of a criminal investigation it is unusual for anyone to determine how wide or deep the illegal conduct goes.

In short, the authority given to corporations to advance expenses provides another opportunity for a convicted executive to receive corporate indemnification without meeting statutory standards. Although it is undoubtedly envisioned by the forty-nine incorporation statutes that explicitly allow these advances that an unworthy executive will not receive an advance, or will return the advance if unworthiness is determined after a verdict, these expectations are unrealistic. To be realistic, the statutory limitations on improper advances and the statutory duty to return advances must be meaningful; as currently drafted, they are not.

e. The significance of convictions and pleas of nolo contendere

Forty-nine state incorporation codes address the relevance of convictions and pleas of nolo contendere;[210] forty-eight of these statutes take a position quite favorable to the convicted executive, providing that termination of a proceeding by conviction or upon a plea of nolo contendere "shall not, of itself, create a presumption" that the executive does not meet the statutory standard for indemnification.[211] Maryland alone rejects this approach by adopting the inverse presumption, albeit a rebuttable one: "The termination of any proceeding by . . . conviction, or upon a plea of nolo contendere or its equivalent creates a rebuttable presumption that the [executive] did not meet the requisite standard of conduct . . . ."[212]

This statement by forty-eight states of the irrelevance of convictions in assessing eligibility for indemnification does two unfortunate things. By its disjunctive phrasing, this pronouncement lends credence to the view that a plea of nolo contendere is somehow different from a con-

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210. California's state incorporation code is the only one not specifically addressing the issue of the relevance of a conviction or plea of nolo contendere. CAL. CORP. CODE § 317 (West 1977 & Supp. 1990).

211. DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1988). There are some variations in the language used but all are to the same effect. For example, Minnesota and North Dakota used the language that termination of a proceeding by conviction, or upon plea of nolo contendere does not, of itself, "establish" that the executive does not meet the statutory standard for indemnification. MINN. STAT. ANN. § 302A.521 subd. 2(b) (West 1985 & Supp. 1990); N.D. CENT. CODE § 10-19.1-91.(3) (1985) (emphasis supplied). The RMBCA provides that termination of a proceeding by conviction or upon a plea of nolo contendere is not, of itself, "determinative" that the executive does not meet the standard for indemnification. RMBCA § 8.51(c) (1984).

212. MD. CORPS. & ASS'NS CODE ANN. § 2-418(b)(3) (1985 & Supp. 1989).

viction. For criminal justice purposes it is not; a plea of guilty, a verdict of guilty by a jury or a court after a trial, and a plea of nolo contendere all result in a conviction of guilt.[213] More ominously, however, this statement tells corporations and their executives that they may ignore the societal condemnation inherent in a criminal conviction.

f. Power given to courts to indemnify

As noted supra,[214] some of the incorporation statutes provide that the court where the proceeding is pending may determine whether an executive qualifies for indemnification. Twenty statutes also provide another role for courts, but not necessarily the court before which the proceeding is pending. These statutes allow a corporate executive to apply "to the court conducting the proceeding" or "to another court of competent jurisdiction" for indemnification and advances of expenses "notwithstanding the failure of a corporation to provide indemnification." If the court determines that the executive "is fairly and reasonably entitled to indemnification . . . in view of all relevant circumstances," the court may order indemnification "despite any contrary determination of the board or of the shareholders," and "regardless of whether or not such person met the standard of conduct set forth in the statute."[215]

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213. A plea of nolo contendere has the same effect as a plea of guilty except that it does not create estoppel. United States v. Norris, 281 U.S. 619, 622 60 S. Ct. 424, 425, 74 L. Ed. 1076, 1077 (1930); UNITED STATES ATTORNEY'S MANUAL §§ 9-16.000, -16.400 (Oct. 1, 1988); W. LAFAVE & J. ISRAEL, CRIMINAL PROCEDURE § 20.4(a), at 801 (1985); FED. R. EVID. 410; MCCORMICK ON EVIDENCE § 265, at 783 (1984).

214. *See supra* note 135 and accompanying text.

215. RMBCA § 8.54(2) (1984). The following states provide some variation of this role for courts: Colorado, Georgia, Iowa, Kentucky, Maryland, Michigan, Mississippi, Montana, New Jersey, New Mexico, New York, North Carolina, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Washington, Wisconsin, and Wyoming. There are numerous variations among the states authorizing this option. Some states are more direct than is the RMBCA in making clear that the court is not bound by an adverse decision on indemnification made by the corporation. For example, New Jersey's statute specifies that a court may award indemnification "notwithstanding a contrary determination" made by the corporation. N.J. STAT. ANN. § 14A:3-5(7)(a)(i) (West 1969 & Supp. 1990). New York's statute is also explicit: It provides that a court may order indemnification "notwithstanding the failure of a corporation to provide indemnification, and despite any contrary resolution of the board or of the shareholders." Notably, however, in New York the court must still use the permissive guidelines in the statute to determine if indemnification is appropriate. N.Y. BUS. CORP. LAW § 724 (McKinney 1986 & Supp. 1990). Although relevant to very few, if any, criminal proceedings, it should be noted that the RMBCA and most of the states following it in this respect, provide that the award by a court is limited to expenses if the executive is adjudged liable in connection with a proceeding by or in the right of the corporation, or in connection with any other proceeding where the executive is charged with receiving an improper benefit and adjudged liable on that basis.

Consider a dramatic example: A convicted executive denied indemnification by the directors, independent counsel, or shareholders of a corporation on the ground that she did not meet the statutory standards for indemnification, could go to any court "of competent jurisdiction" and seek indemnification. As long as this court found that the executive was "fairly and reasonably entitled to indemnification," it could order indemnification.

This provision may be appropriate in cases where a hostile take-over has occurred. In such an instance, new directors may refuse to authorize mandatory or permissive indemnification, however appropriate it may be according to statutory standards. In such circumstances, resort to an independent fact-finder is needed. There are, however, two areas of potential abuse presented by this authorization avenue when it is available beyond the hostile take-over situation. First, allowing an executive to go to a court other than the one before whom the proceeding at issue is pending encourages blatant forum shopping, a lack of awareness by the new tribunal of relevant facts, and disrespect of the original tribunal. At a minimum, allowing an executive to go to a tribunal that is not familiar with the prior proceeding unnecessarily absorbs scarce judicial resources by duplicating the work of the first tribunal. The second potential for abuse posed by this provision is that it allows a court to order indemnification by applying a standard more lenient than that already set forth in the statute. The vagueness of the "fairly and reasonably entitled" standard, coupled as it is with the declared expectation that the executive will not have met the other standards of conduct set forth in the statute, leaves too great of a possibility that a convicted executive will be indemnified by a court indifferent to, or unaware of, the executive's malfeasance.

This provision is a prime example of a protection needed for one particular situation but inappropriately expanded to other situations. Allowing this avenue to be used in the criminal arena where it is subject to abuse only serves to further threaten the unique policy concerns presented by the criminal justice system.

g. Mandated disclosure to shareholders

One suspects that requirements for shareholder notification of the indemnification paid to corporate executives detrimentally influences a convicted executive's chance for indemnification. It is unlikely that observant shareholders will favor an expenditure of corporate funds to pay attorney fees, fines, or penalties for an executive who has committed crimes in the exercise of his corporate duties. The risk of inquiries, publicity, and even shareholder derivative suits for breach of duty in granting overly generous indemnification undoubtedly serves as a chilling influence on those who are asked to authorize indemnification.

The opportunities and requirements for shareholder notification of indemnification payments are hidden in the patchwork of indemnification rights. Seven states require that shareholders be informed of indemnification made pursuant to the incorporation statute but such disclosure is required only when the indemnification is for claims arising in actions "by or in the right of the corporation."[216] There are only four statutes that require disclosure of indemnification to an executive who has been convicted of crimes.[217]

Interestingly, shareholders may have greater rights of notification if the indemnification is made outside of the incorporation statute, for example, if the indemnification is made pursuant to power granted by articles of incorporation or bylaws. Most incorporation statutes require shareholder approval to amend the articles of incorporation,[218] and provide that the shareholders share in the power to amend bylaws.[219] There are problems with this level of notice however: shareholders change, the articles or bylaws authorizing indemnification probably do not require notice of each instance of indemnification, and, the fact that the indemnification permitted in the articles or bylaws includes indemnification to executives convicted of crimes may be so hidden in legalese that shareholders do not realize that they have authorized indemnification for criminal liability.[220] Indemnification pursuant to contracts negotiated between a corporation and executives may offer the greatest degree of secrecy. Rarely will anyone but the parties signing the contract know of its terms.

In short, it will be unusual for shareholders to learn that corporate funds are being used to pay a convicted executive's attorney fees, fines,

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216. Iowa, Maryland, Minnesota, Montana, New Mexico, North Dakota, Rhode Island. *See supra* note 11 for statutory citations.

217. Florida, Illinois, Nebraska, New York. *See supra* note 11 for statutory citations.

There are variations among these provisions that limit this disclosure requirement. For example, Florida and New York require disclosure only when indemnification is authorized by the corporate directors or "independent legal counsel." FLA. STAT. ANN. § 607.014(13) (West 1986 & Supp. 1989); N.Y. BUS. CORP. LAW § 725(c) (McKinney 1986 & Supp. 1990).

218. Amendments to articles of incorporation are almost always initiated by the board of directors, but in almost four-fifths of the states, shareholder approval of amendments is necessary. 3 MODEL BUSINESS CORP. ACT ANN. § 10.03 Official Comment and Statutory Comparison (3d ed. Supp. 1990).

219. At common law shareholders retained the sole power to amend or repeal bylaws. Today this power is shared by the board of directors and shareholders. The major reason for this is convenience; it is usually cheaper and easier for a board of directors to meet to amend bylaws than it is to call a shareholders' meeting. 3 MODEL BUSINESS CORP. ACT ANN., *supra* note 218, § 10.20 (Official Comment, Historical Background, and Statutory Comparison).

220. For sample bylaws see BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at app. 7A; P. RICHTER, INDEMNIFICATION OF DIRECTORS AND OFFICERS, *supra* note 2.

or penalties. Only four states require such disclosure when the indemnification is made pursuant to an incorporation statute. The disclosure available when indemnification is made outside the indemnification statute, that is, pursuant to articles of incorporation or bylaws, is unlikely to be specific enough to be helpful. No disclosure is likely when indemnification is made pursuant to a contract negotiated between the corporation and the executive. This lack of notice to shareholders seems unjustifiable in any indemnification circumstance because of the shareholders' financial stake in such payments, but it seems especially egregious when the payments are to an executive convicted of crimes. In this situation shareholders should have the special opportunity, and responsibility, to determine whether the use of their equity is circumventing the criminal justice system.

h. Miscellaneous restrictions

Numerous statutory codes provide additional limitations on indemnification that may apply to criminal actions. For example, New York's indemnification statute provides that no indemnification, advancement or allowance shall be made when it would be inconsistent with the law of the incorporating jurisdiction of a foreign corporation, the certificate of incorporation, the bylaws, a corporate resolution, an agreement, or a court-approved settlement.[221] None of these restrictions will consistently limit indemnification of convicted executives. To the extent "the law of the jurisdiction of incorporation" refers to principles of public policy, this limitation is unreliable because, as noted,[222] courts erratically recognize and apply principles of public policy to limit indemnification. Reliance upon limitations in certificates of incorporation, bylaws, resolutions and agreements is illusory because there will rarely be limitations on indemnification in these sources; more often than not they generously grant indemnification. Lastly, it is unlikely that court-approved settlements will consistently limit indemnification. Courts may not be sufficiently aware of the indemnification issue to include it in a settlement, and the courts that do so may not resolve the indemnification issue uniformly, or even wisely.

Iowa contains the following limitation: "indemnification shall not be provided . . . for acts or omissions . . . which involve intentional misconduct or a knowing violation of the law. . . ."[223] To the extent a

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221. N.Y. Bus. Corp. Law § 725(b) (McKinney 1986 & Supp. 1990).

222. See *supra* text accompanying notes 159-98.

223. Iowa Code Ann. § 496A.4A(7) (West Supp. 1990). Several states have similar provisions. For example, Arizona prohibits indemnification if there has been a "final adjudication establish[ing] that acts of active and deliberate dishonesty committed by the

criminal conviction demonstrates "intentional misconduct" or a "knowing violation of the law," this limitation should prevent indemnification even if it was determined that the convicted executive met the standards for permissive indemnification. However, this limitation may be deemed inapplicable when the corporate executive has been convicted for reckless disregard of truth or falsity, or convicted upon a finding of ignorance — even deliberate ignorance.

Another limitation that may apply to criminal matters, depending upon the facts, is contained in several statutes. This limitation provides that a corporation may not indemnify "in respect of any proceeding charging improper personal benefit . . .in which [the executive] was adjudged to be liable on the basis that personal benefit was improperly received."[224] Most obviously, this prohibition applies to shareholder derivative suits charging self dealing. To the extent a conviction also rests upon findings of personal benefit, this prohibition may limit indemnification to the convicted executive. Sometimes, convictions in some criminal cases will imply that the defendant improperly received a personal benefit. For example, in 1989 Michael R. Milkin was indicted on charges that he "enriched [himself] through unlawful securities trading."[225] However, allegations or proof of such self dealing will not always be present. Major white collar crimes such as mail fraud,[226] securities fraud,[227] and RICO,[228] may all be charged and proven without any evidence of self dealing. Thus, this restriction will not consistently apply to indemnification sought by convicted executives.

Of all of the miscellaneous limitations in incorporation statutes, a provision in Pennsylvania's statute may have the greatest potential applicability to convicted executives. Pennsylvania's statute provides that "[i]ndemnification . . . shall not be made in any case where the act or failure to act giving rise to the claim for indemnification is determined by a court to have constituted willful misconduct or recklessness."[229] To the extent this provision applies to all actions, not simply shareholder derivative suits, and to the extent it extends to instances of recklessness,

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person with actual dishonest purpose and intent [which] were material to the cause of action adjudicated." ARIZ. REV. STAT. ANN. § 10-005(I) (1990). *See also* MO. ANN. STAT. § 351.355(7) (Vernon 1966 & Supp. 1990); VA. CODE ANN. § 13.1-704 (1989).

224. MD. CORPS. & ASS'NS CODE ANN. § 2-418(c) (1985 & Supp. 1989). *See, e.g.*, COLO. REV. STAT. § 7-3-101.5(2)(d)(II) (Supp. 1990); FLA. STAT. ANN. § 607.014(7) (West 1986 & Supp. 1989); MISS. CODE ANN. § 79-4-8.51(d)(2) (1972 & Supp. 1988).

225. United States v. Milkin, Cause Number S 89CR. 41(KBW), Indictment at 4 (S.D.N.Y. 1989).

226. 18 U.S.C. § 1341 (Supp. 1990).

227. 15 U.S.C. § 78j (1981).

228. 18 U.S.C. § 1961-1964 (Supp. 1990).

229. 15 PA. CONS. STAT. ANN. § 1746(b) (Purdon 1990).

this provision could provide a meaningful limitation on indemnification to convicted executives, even when the statutory standards for permissive indemnification are determined to have been met. The language, "is determined by the court," clouds the applicability of this standard somewhat, however. If an explicit finding by a court is essential before this prohibition applies, and an implicit finding contained in a jury's guilty verdict is insufficient, Pennsylvania's limitation may have an impact only when there is a bench trial, rather than a jury trial, and only when the court issues specific findings supporting its verdict of guilty.

Significantly, however, none of these limitations, including that of Pennsylvania's, may effectively limit indemnification to convicted executives when the statute is nonexclusive, since in nonexclusive jurisdictions corporations are allowed to disregard all statutory limitations in indemnifying executives.

C. Summary of Indemnification by Corporations

A corporation is empowered to indemnify its executives through the incorporation statute of the state where it is incorporated. Although the statutes vary in their definitions of "success," all statutes require that corporations indemnify executives who have been successful in defending the charges against them. Depending upon the definition of "success," executives convicted in part may qualify for mandatory indemnification. Incorporation statutes also permit corporations to indemnify executives who have not successfully defended themselves on the criminal charges if the executives qualify for "permissive" indemnification. Convicted executives can easily qualify for permissive indemnification under most incorporation statutes despite their convictions because of trends in criminal law regarding proof of mens rea; the standards that must be met to qualify for permissive indemnification; the procedure for determining whether an executive has met these standards; the explicitly insignificant relevance attributed to a criminal conviction by most statutes; and, the secrecy in which indemnification may be granted.

Moreover, even if the convicted executive fails to qualify for permissive indemnification, she may still receive indemnification through a variety of statutory avenues that dispense with the need for compliance with the permissive standards. Twenty states allow a court to order indemnification even if the permissive standards have not been met.[230] Forty-eight states allow corporations to disregard the statutory standards for indemnification to some extent, if not altogether, and order indemnification pursuant to bylaws, resolutions or privately negotiated con-

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230. *See supra* note 215 and accompanying text.

tracts.[231] Lastly, forty-nine statutes explicitly allow advances of litigation costs. These advances may result in defacto indemnification to a convicted corporate executive who is ultimately found to be incapable of meeting statutory standards. There are no meaningful requirements for a preliminary assessment of eligibility for indemnification before the advance is made, and there is no meaningful mechanism to enforce repayment of advances if the executive is later found to be utterly incapable of meeting the permissive standards.[232]

The only limit on indemnification legitimately made through the above avenues is a review by the courts to determine if the indemnification frustrates public policy. However, because the courts review only a fraction of indemnification awards, and because they erratically interpret and apply principles of public policy, this is an unpredictable and ineffectual limit on improper indemnification.

Despite this seemingly good news for the convicted executive, she may still have cause for concern. A corporation's willingness to indemnify its executives depends upon the corporation's economic stability and leadership. The corporation with few or no assets cannot indemnify anyone. And, if the officials charged with authorizing indemnification are hostile to the executive seeking indemnification, or determine that the executive has failed to meet necessary standards, there is little chance indemnification, statutory or otherwise, will be paid by the corporation. For this reason many executives turn to D&O liability insurance for reimbursement. It is less likely, however, that the convicted executive will fare well with D&O insurers.

II. D&O Insurance for Convicted Executives

A. OVERVIEW

D&O insurance has expanded tremendously since the first two policies were sold in 1962.[233] Currently, every state incorporation code, except that of Vermont,[234] specifically authorizes corporations to purchase D&O insurance even allowing coverage of costs not indemnifiable by the corporation. The Delaware code, followed by forty-eight states,[235] pro-

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231. *See supra* notes 25, 27 and 28.

232. *See supra* notes 199-209 and accompanying text.

233. Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1078 n. 1.

234. Vt. Stat. Ann. tit. 11, § 1852(15) (1984).

235. All states except Vermont and New York follow the Delaware provision. Vermont's statute does not address the insurance issue, Vt. Stat. Ann. tit. 11, § 1852(15) (1984), and New York's provides limitations on a corporation's power to obtain insurance,

vides . . . that "[a] corporation shall have the power to purchase and maintain insurance on behalf of any [corporate executive] . . . whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section."[236]

D&O insurance provides coverage for losses arising from wrongful acts committed by directors and officers, and in some cases, by other employees.[237] A "wrongful act" includes "any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the [insureds] . . . claimed against them solely by reason of their being [executives] of the company."[238] Losses covered include "damages, judgments, settlement and costs, charges and expenses, incurred in the defense of actions, suits or proceedings and appeals".[239]

D&O policies insure only losses arising from liability on the part of corporate executives; this insurance is not available for losses arising from corporate liability.[240] D&O insurance provides two types of coverage: It reimburses a corporation for amounts it has indemnified its officers and directors, and it reimburses officers and directors personally if they have incurred liabilities not indemnified by the corporation.[241] Ninety-five percent of all claims filed on D&O policies are by corporations for indemnification they have paid to directors or officers.[242] Direct reimbursement to executives is needed only when the corporation cannot, or will not, indemnify its directors and officers. A corporation cannot indemnify its executives if the applicable corporate code, bylaws, re-

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N.Y. Bus. Corp. Law § 726(b) (McKinney 1986 & Supp. 1990). Many of the statutes otherwise modeled after Delaware's insurance provision provide additional specific authority to create alternative funding sources for D&O insurance. *See, e.g.*, Md. Corps. & Ass'ns Code Ann. § 2-418(l)(3) (1985 & Supp. 1989); Nev. Rev. Stat. § 78.752(2) (Michie 1987); Tex. Bus. Corp. Ann. § 2.02-1(R) (Vernon 1980 & Supp. 1990).

236. Del. Code Ann. § 145(g) (1983 & Supp. 1988).

237. Johnston, *Indemnification and Insurance*, *supra* note 8, 33 Bus. Law. at 2015-16.

238. J. Bishop, Indemnification and Insurance, *supra* note 1, app. 8A, at 52 (Stewart Smith Form) (1981 & Supp 1990).

239. *Id.*

240. *Id.* ¶ 8.07; Note, *Practical Aspects of D&O Insurance*, *supra* note 8, 32 UCLA L. Rev. at 692.

241. *See, e.g.*, Johnston, *Indemnification & Insurance*, *supra* note 8, 33 Bus. Law. at 2013; Note, *Protecting Corporate Directors and Officers: Insurance and Other Alternatives*, 40 Vand. L. Rev. 775, 783 (1987) [hereinafter *Insurance and Other Alternatives*].

242. The 1982 Wyatt Directors and Officers And Fiduciary Liability Survey: Comprehensive Report 61 (1982) [hereinafter The 1982 Wyatt Survey]. The Wyatt Company is an international pension, actuarial and risk management consulting organization. In its 1982 Survey of Directors and Officers Liability Insurance, 1,979 American corporations and 275 Canadian corporations participated. *Id.* at Introduction.

solutions or contracts forbid indemnification, or if the corporation is insolvent. A corporation may choose not to indemnify its executives if there has been a change in management or if management determines that the executive does not qualify for indemnification.

The claims filed with D&O insurers are large; in 1988 the total average claim was $1,848,000.[243] Of this total claim, a surprising percentage is attributable to attorney fees. The 1988 Wyatt Survey estimated that the average defense cost was $693,000, over one-third of the total average claim.[244] Moreover, attorneys fees have risen astronomically — in 1974 the average defense cost was $182,000.[245] The number of companies experiencing D&O claims is also increasing. In 1987, the Wyatt Survey estimated that 20% of the Fortune listed companies will experience a D&O claim each year.[246] This is double the frequency of claims in 1981.[247] Approximately 47% of the D&O claims arise from litigation brought by shareholders, 22% arise from litigation brought by employees or former employees, and 20% arise from litigation brought by customers.[248]

In the 1980s a "crisis" emerged in D&O coverage.[249] This crisis was fueled, in part, by a landmark case which made it easier for plaintiffs

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243. The 1988 Wyatt Directors and Officers Liability Survey 12 (1988) [hereinafter The 1988 Wyatt Survey]. *See supra* note 242 regarding The Wyatt Company. The 1988 Survey is the eleventh survey the Wyatt Company has conducted regarding directors and officers liability insurance markets. In this survey, 1,708 American business corporations participated. *Id.* at 1.

244. *Id.* at 12. The Wyatt Survey noted that 421 of the 759 claims reported (55.4%) failed to disclose defense costs. The surveyors did not know if companies otherwise participating in the survey were reluctant or unable to disclose such costs. *Id.* at 14. The average defense expenses associated with claims filed but dropped were $146,150; the average defense expenses for settled claims were $396,881; and, the average defense expenses for claims closed through litigation were $330,906. *Id.* at 15.

245. *Id.* at 15.

246. The 1987 Wyatt Directors and Officers and Fiduciary Liability Survey 11 (1987) [hereinafter The 1987 Wyatt Survey]. *See supra* note 242 regarding the Wyatt Company. The 1987 survey is the tenth survey the Wyatt Company has conducted regarding directors and officers liability insurance markets. In this survey, 895 American and 152 Canadian companies participated. *Id.* at 1-3.

247. The 1982 Wyatt Survey, *supra* note 242, at 11.

248. The 1988 Wyatt Survey, *supra* note 243, at 116.

249. *See, e.g.*, Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 Bus. Law at 1207; Hazen, *The Race to the Bottom*, *supra* note 20, 66 N.C.L. Rev. at 171, 179; Veasey, Finkelstein & Bigler, *Responses to the D & O Insurance Crisis*, 19 Rev. Sec. & Commodities Req. 263 (1986) [hereinafter *Responses*]; Johnston, *Indemnification and Insurance*, *supra* note 8, 33 Bus. Law at 1993; Heyler, *Indemnification of Corporate Agents*, *supra* note 20, 23 UCLA L. Rev. at 1255; Purcell, *D & O Liability - New Protection*, Business 50-52 (Jul.-Sept. 1988); Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1078-79; Note, *Indemnification of Directors*, *supra* note 4, 76 Harv. L. Rev. at 1403.

to hold corporate executives liable. In *Smith v. Van Gorkom*,[250] a shareholders class action,[251] the Delaware Supreme Court held that the directors of Trans Union, a publicly traded, diversified holding company, failed to exercise adequate business judgment in approving a cash-out merger[252] and were personally liable for the fair value of the plaintiffs' shares of Trans Union. The Court reached this conclusion despite the facts that the $55 price per share negotiated was $27 higher than the current market price;[253] the merger proposed was approved by 69.9% of outstanding shares; the Board met three times over a four month period to discuss the merger; and, at the initial meeting an attorney hired to provide advice on this merger advised the Board members that they might be sued if they did not approve the merger.[254] The nine Trans Union directors were held personally liable for $23.5 million.[255]

There followed a "record number" of cases holding directors and officers liable for breaches of their duties of care and loyalty.[256] Several stunning judgments were rendered. In 1984, insurers paid $25 million to settle a shareholder derivative claim against a Los Angeles retailer.[257] In 1985, a Delaware court approved a $32.5 million settlement against Chase Manhattan Bank Corporation and its officers.[258]

In response to these developments, D&O insurers raised premiums and deductibles. Sixty-four percent of corporations renewing their D&O insurance in late 1985 and 1986 faced increases of 100% in premiums; 20% faced increases of 1000%.[259] Premiums are still on the rise.[260] Deductibles for personal coverage increased an average of 44% between 1984 and 1987, while deductibles for corporate coverage increased by 196%.[261] D&O insurers also increased the number and scope of exclu-

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250. 488 A.2d 858 (Del. 1985).

251. *Id.* at 863.

252. *Id.* at 863-64.

253. *Id.* at 875.

254. *Id.* 870, 868

255. Olson, *Why Directors Keep Getting Sued*, FORTUNE 14 (Mar. 13, 1989) (It should be noted that insurance covered less than half of this amount but the purchaser of Trans Union's stock volunteered to pick up most of the director's bill.).

256. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.01; Note: *Insurance and Other Alternatives*, *supra* note 241, 40 VAND. L. REV. at 780.

257. Hilder, *Liability Insurance is Difficult to Find Now for Directors and Officers*, Wall St. J., July 10, 1985, at 1, col. 6.

258. Fox v. Chase Manhatten Corp., No. 8192-85 (Del. Ch. Dec. 9, 1985) (LEXIS, Del. library, Cases file); Sloane, *Insurer-Management Liability Rift Seen Growing*, N.Y. TIMES, Dec. 19, 1985, at D8, col. 1.

259. THE 1987 WYATT SURVEY, *supra* note 246, at 89-95.

260. THE 1988 WYATT SURVEY, *supra* note 243, at 45.

261. *Id.* at 75.

sions.[262] These changes in exclusions had an effect: in 1988, over one-fourth of claims filed against D&O insurers were outside the policy, or coverage was unclear.[263]

The response to this "crisis" by the insurers has had an impact on companies holding D&O insurance. In 1984, 70% of small companies (assets under $10 million) held D&O insurance.[264] Three years later, in 1987, only 29% of small companies held such insurance.[265] The reasons given for not buying D&O insurance are telling. Between 1984 and 1987 the percentage of companies indicating that they thought D&O insurance was important increased, but the percentage of companies not buying insurance, either because it was too expensive or because the coverage provided was too limited, rose from 1.7% to 9.5%.[266] Interestingly, the large companies (assets of $2 billion or more) have consistently maintained D&O coverage, even throughout this "crisis" period. Approximately 95% of corporations with assets of $2 billion or more maintain D&O coverage.[267] In part, such coverage is still feasible for these larger companies because they are able to secure financing alternatives not available to smaller companies.[268]

The 1987 Wyatt Survey attempted to determine whether these changes in liability and insurance coverage have truly created a crisis, making it more difficult to hire capable directors and officers.[269] The Survey

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262. Note, *Insurance and Other Alternatives*, *supra* note 241, 40 Vand. L. Rev. at 776-777.

263. The 1988 Wyatt Survey, *supra* note 243, at 17. This is a "relative increase" in claims falling outside policy provisions but not a dramatic increase. *Id.* at 18. The 1982 Wyatt Survey showed that in 1980, 31.6% of claims fell outside the policy or coverage was uncertain. *See supra* note 242, at 22.

264. The 1984 Wyatt Directors and Officers and Fiduciary Liability Survey 64 (1984) [hereinafter The 1984 Wyatt Survey]. *See supra* note 242 for a description of the Wyatt Company. In its 1984 Survey, 1,451 American and 201 Canadian companies participated. *Id.* at 5.

265. The 1987 Wyatt Survey, *supra* note 246, at 51. It is not possible to determine if 1988 showed a reversal of this trend, at least from the Wyatt Surveys, because the 1988 Wyatt Survey broadened its category for small companies. Beginning with the 1988 Survey, the Wyatt Company expanded its category for small companies to include companies with assets under $50 million, instead of limiting this category to companies with assets under $10 million.

266. *Id.* at 50, 55.

267. The 1987 Wyatt Survey indicated that 95.9% of companies with assets of $2 billion or more held D&O insurance. The 1984 Wyatt Survey found that 97.2% of such companies held D&O insurance. *Id.* at 51.

268. *See, e.g.*, Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 8.01; Carlton & Brooks, *Corporate Director and Officer Indemnification: Alternative Methods For Funding*, 24 Wake Forest L. Rev. 53 (1989); Note, *Insurance and Other Alternatives*, *supra* note 241, 40 Vand. L. Rev. at 793-803.

269. The 1987 Wyatt Survey, *supra* 246, at 161; *see also* Bishop, *Sitting Ducks*

found that 8.8% of the companies participating in its 1987 study had been unable to obtain adequate D&O coverage. A little over one-fourth of these companies stated that they lost some board members because of this failure.[270] Whether this crisis is fact or fiction, however, state legislatures[271] have acted to aid corporations and corporate executives.[272]

B. D&O Coverage for the Convicted Executive

Compared to corporate indemnification, D&O insurance provides less of an opportunity for convicted executives to receive reimbursement for costs associated with criminal liability. Historically, insurance coverage has not been available for deliberate and willful acts.[273] The definition of "loss" in most D&O policies grows out of this history. These policies specifically provide that the "loss" covered by the policies "shall not include fines or penalties imposed by the law or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed."[274] This definition would seem to exclude insurance coverage for any costs incurred by a convicted executive.

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and Decoy Ducks, *supra* note 8, 77 Yale L.J. at 1078. Bishop questions whether this "crisis" has been created by "aggressive and imaginative propaganda of underwriters." *Id.*

270. The 1987 Wyatt Survey, *supra* note 246, at 161.

271. As discussed in Part One, one response by legislatures has been to increase the power of corporations to indemnify executives. For other sources discussing this as a response to the perceived crisis see The 1987 Wyatt Survey, *supra* note 246 at 161; Hazen, *The Race To The Bottom*, *supra* note 20, 66 N.C.L. Rev. at 177-79; *see generally* Carlton & Brooks, *Corporate Director and Officer Indemnification: Alternative Methods For Funding*, *supra* note 268, 24 Wake Forest L. Rev. 53; Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 Bus. Lawyer at 1221-1227.

272. *See, e.g.*, Veasey, Finkelstein & Bigler, *Responses*, *supra* note 249, 19 Rev. Sec. & Commodities Reg. 263; Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1079.

Another response has been authorization for corporations to amend their charter with provisions limiting or eliminating director liability for money damages. Delaware pioneered this approach when it passed Del. Code Ann tit. 8, § 102(b)(7) (1988):

> [T]he certificate of incorporation may also contain . . . [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law, (iii) under section 174 of this title, or (iv) for any transaction from which the director derived an improper personal benefit."

273. *See supra* note 159-168 and accompanying text.

274. *See, e.g.*, J. Bishop, Indemnification and Insurance, *supra* note 1, app. 8A, at 33 (American Adaptation of Lloyd's two-part form), at 52-53 (Stewart-Smith form);

Some commentators, however, have suggested that this definition does not exclude coverage for criminal or other intentional acts.[275] They rely on the phrase, "matters which are uninsurable under the law pursuant to which this policy shall be construed." In some jurisdictions, the law pursuant to which an insurance policy is construed allows insurance coverage of intentional or even criminal misconduct.[276] In these jurisdictions the definition of loss, by explicitly incorporating this applicable law, may extend to intentional or criminal misconduct.

Upon full examination of what is excluded as a loss in a D&O policy, however, this suggested interpretation appears to be incorrect. The "fines or penalties" excluded from the policy definition of loss is not qualified by the reference to "matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed"; rather, the reference to uninsurable matters is an additional exclusion to "fines or penalties." As such, all fines and penalties are excluded, not just those deemed uninsurable by the law of a particular jurisdiction. Nevertheless, it is worth noting that if a court finds this definition to be ambiguous, costs incurred by a convicted executive may be covered since ambiguities in policies are resolved in the insured's favor.[277]

There is an additional argument that has been made as to why fines and penalties should be covered by D&O policies. Professor Bishop suggested that the D&O policy definition of "loss" should extend to costs incurred by a convicted executive when the corporation is empowered to indemnify these costs because "a corporation should be able to validly contract with an insurer for reimbursement of any payment that . . . applicable statutes . . . permit it to make by way of indemnification."[278] Admittedly, there is some merit to this argument for allowing corporations to obtain insurance coverage coextensive with its powers to indemnify. However, this Article suggests that a better policy argument can be made that such symmetry should be achieved by restricting the corporation's indemnification authority, not by expanding the coverage of the insurer.

The "dishonesty" exclusion contained in most D&O policies is also relevant in assessing the insurability of costs incurred by a convicted

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P. Richter, Indemnification of Directors and Officers, *supra* note 2, at app. 2-6 (Ipalco Enterprises, Inc. Form - corporate reimbursement policy) and at app. 2-18 (Ipalco Enterprises, Inc. Form - directors and officers reimbursement).

275. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 8.10; Note, *Insurance For Executives*, *supra* note 8, 80 Harv. L. Rev. at 665-66.

276. *See supra* notes 187-197 and accompanying text.

277. Couch, 2 Cyclopedia of Insurance Law § 15:83 (2d ed. 1984); 7A Appleman, Insurance Law & Practice § 4491.01 (Berdal ed. 1979); Keeton, Insurance Law, Basic Text § 5.5(a)(2) (1971).

278. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 8.10.

executive. The applicability of this exclusion to such costs depends upon its precise wording, which varies considerably from policy to policy.

The following dishonesty exclusion, which focuses upon "a judgement . . . [of] criminal acts," has been criticized for its ambiguity,[279] which would, of course, require that it be resolved in the insured's favor. Aside from this problem, however, this particular exclusion is not favorable to a convicted executive. It provides:

> The insurer shall not be liable to make any payment for loss in connection with any claim or claims made against the insureds . . . brought about or contributed to by the fraudulent, dishonest or criminal acts of the insureds, however the provisions of this exclusion shall not apply unless a judgment or other final adjudication thereof adverse to the insureds shall establish fraud, dishonesty or criminal acts. . . .[280]

Thus, this dishonesty exclusion makes a conviction conclusive on the insurability issue. If the executive is acquitted or secures dismissal of charges, there is no "judgment or other final adjudication" of "fraud, dishonesty or criminal acts" and the executive's costs would be insurable under this provision. On the other hand, if the executive is convicted, there has been a "judgment" and "final adjudication" of "criminal acts" and the executive's costs would be excluded from coverage. One advantage of this particular dishonesty exclusion is that it is simple and easy to administer. Such a claim cannot be made for some of the other dishonesty exclusions.

The Stewart Smith D&O Insurance form, upon which many American policies are based,[281] includes the following dishonesty exclusion:

> Except insofar as the company may be required or permitted by law to pay as indemnity to the directors and officers, the underwriters shall not be liable to make any payment for loss in connection with any claim made against directors or officers . . . brought about or contributed to by the dishonesty of the directors and officers; however, notwithstanding the foregoing, the directors shall be protected under the terms of this policy as to any claims upon which suit may be brought against them by reason of any alleged dishonesty on the part of the directors

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279. *See* Johnston, *Indemnification and Insurance*, *supra* note 8, 33 Bus. Law., at 2019-2020; Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1088-89; Note, *Practical Aspects of D&O Insurance*, *supra* note 8, 32 UCLA L. Rev. at 701.

280. This exclusion is contained in the American adaptation of Lloyd's two-part form. J. Bishop, Indemnification and Insurance, *supra* note 1, app. 8A, at 43. This form, and the Stewart Smith form, are the models for many of the D&O policies in current use. *Id.* at ¶ 8.04.

281. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 8.04.

> or officers, unless a judgment or other final adjudication thereof adverse to the directors or officers shall establish that acts of active and deliberate dishonesty committed by the directors or officers with actual dishonest purpose and intent were material to the cause of action so adjudicated.[282]

This prolix provision contains two features that make it quite possible to find that costs incurred by a convicted executive are insurable. First, the exclusion specifically states that it does not apply if the company is "permitted by law to pay . . . indemnity to the directors and officers." As we have seen, virtually all incorporation statutes easily permit corporations to indemnify convicted executives. Thus, this dishonesty exclusion simply will not apply to most instances when an executive has been convicted.

Second, even if this exclusion does apply, it may be difficult to find "dishonesty" under it, primarily because of the law on mens rea in white collar criminal cases. Unlike the prior dishonesty exclusion which excludes coverage whenever there is a conviction, this dishonesty exclusion applies only when there is a "judgment or other final adjudication" establishing that the executive committed "acts of active and deliberate dishonesty . . . with actual dishonest purpose and intent."[283] A simple verdict of guilty will not provide sufficient detail to determine if "active and deliberate dishonesty" is present. Moreover, when one digs through the evidence and applicable law, it is more likely that one will find "gray areas" of criminality, or recklessness, or deliberate disregard of facts, rather than "active and deliberate dishonesty" or "actual dishonest purpose." As always, of course, to the extent the above dishonesty exclusion is unclear, it helps convicted executives since an ambiguous insurance policy is to be construed in the insured's favor.[284]

A D&O insurer's obligation to advance attorneys fees before judgment has been rendered varies from jurisdiction to jurisdiction depending upon how the courts interpret provisions in the policies.[285] D&O policies are viewed as "indemnity," not "liability" policies. Under an "indemnity" policy, an insurer is not obligated to pay until after the insured has been held liable and paid, out of his own pocket, an actual monetary amount. The insurer then indemnifies the insured directly.[286] In contrast, under a liability policy, the insurer becomes obligated to pay before the

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282. *Id.*, app. 8A, at 54.

283. *Id.*

284. *See supra* note 277.

285. *See generally* Note, *Practical Aspects of D&O Insurance*, 32 UCLA L. Rev. at 691.

286. Couch, 11 Couch on Insurance § 44.4 (2d. 1982).

insured suffers any out-of-pocket loss.[287] Attorneys fees complicate this distinction because criminal defendants, or potential criminal defendants, are obligated to pay attorneys fees as the fees are incurred, which is usually long before any judgment of liability is rendered.

Court opinions addressing the D&O insurers' obligation to advance attorneys fees are split. The opinions focus on the language in insurance policies but often reach different conclusions about similar language. In *Okada v. MGIC Indemnity Corporation*,[288] the United States Court of Appeals for the Ninth Circuit held that an insurer had a duty to reimburse attorneys fees as they are incurred. Finding ambiguity in the contractual language, the court construed the ambiguity in the insured's favor, holding that the insurer had an obligation to pay the legal expenses of the corporate executive as the expenses came due, rather than when the case was completed.[289] Other courts that have reached the same conclusion as the Ninth Circuit have found similar terms to be ambiguous.[290] As noted,[291] the United States Court of Appeals for the Third Circuit added another reason for construing the D&O insurance policy to cover attorneys fees as incurred. It found that because the legal fees could be "staggering," any contractual provision allowing the insurer "absolute discretion over the timing of reimbursement of defense costs" would be "unconscionable."[292]

Zaborac v. American Casualty Co.[293] represents the opposite view. In this case, a federal district court held that unless it is specifically spelled out as a contractual duty, insurers are not obliged to advance

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287. 6B Appleman, Insurance Law & Practice § 4261 (Buckley ed. 1979); *cf.* Couch, 11 Couch on Insurance § 44.4 (2d 1982).

288. 823 F.2d 276 (9th Cir. 1986) (amending and correcting 795 F.2d 1450 (9th Cir. 1986)).

289. *Id.* at 281-282.

290. Gon v. First State Ins. Co., 871 F.2d 863 (9th Cir. 1989); American Cas. Co. v. Bank of Montana System, 675 F. Supp. 538 (D. Minn. 1987); Little v. MGIC Indem. Corp., 649 F. Supp. 1460 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987); Pepsico v. Continental Casualty Co., 640 F. Supp. 656 (S.D.N.Y. 1986).

The policy language in *Gon* and *Little* was identical to that in *Okada*. The policy language in *Pepsico*, unlike the policies in *Okada*, *Little* and *Gon*, did not have language that expressly allowed the insurer to advance defense costs at its option. *Pepsico*, 640 F. Supp. at 660. Instead, the court found that the insurer had agreed to reimburse Pepsico for defense costs "whenever Pepsico 'may be required or permitted by law' to reimburse its directors and officers." *Id.* The court then found that Pepsico, through a by-law, "broadened its ability to indemnify its directors and officers" so that the advanced attorneys fees were covered. *Id.* at 661.

291. *See supra* note 186 and accompanying text.

292. *Little*, 649 F. Supp. at 1468.

293. 663 F. Supp. 330 (C.D. Ill. 1987). *See also* American Cas. Co. of Reading Pa. v. FDIC, 677 F. Supp. 600 (N.D. Iowa 1987) and cases cited therein.

legal fees as these fees are incurred.[294] Addressing the same contractual terms as the *Okada* court, the court in *Zaborac* found the terms clear and held that the insurer was not obligated to pay any covered "loss" until the case was concluded and the court had made certain findings relevant to coverage[295] (i.e. regarding fraud, dishonesty, etc.). *Zaborac* never addressed the unconscionability argument raised by the "staggering" size of attorneys fees.

Currently, therefore, the law is unclear as to whether D&O insurers are obligated to reimburse attorneys fees as those fees are incurred. Because of this uncertainty corporations, corporate executives, and insurers are on notice to negotiate and draft D&O policies so as to explicitly spell out their intention as to whether coverage includes payment of attorneys fees prior to final judgment.[296]

III. Summary, Assessment and Proposal

A. *Summary*

Assume a corporate executive becomes the target of grand jury investigation or is indicted. During the investigation, pretrial negotiations, and trial if one occurs, the executive incurs hundreds of thousands of dollars in attorneys fees. Although there may not yet be a judgment that would indicate whether or not the executive qualifies for indemnification from the relevant corporation or reimbursement from the applicable D&O insurer, it is likely that the executive will seek an advance to cover these attorneys fees. If the executive seeks the advance from the corporation and meets statutory criteria (virtually pro forma)[297] he will receive the advance without posting security or proving an ability to repay if he is ultimately found ineligible for indemnification. If the executive seeks an advance from the D&O insurer, or if the corporation seeks coverage for amounts it advanced to the executive, the law is unclear and the policy language and the jurisdiction will determine whether coverage is available.[298]

If the grand jury does not return charges against the executive or if the executive is acquitted on all charges, he will be entitled to mandatory indemnification from the corporation for all attorneys fees and other

294. *Zaborac*, 663 F. Supp. at 333-34.

295. *Id.* at 332.

296. *Cf.* Note, *Practical Aspects of D&O Insurance*, *supra* note 8, 32 UCLA L.Rev. at 712-715 and 717-718 (suggesting that D&O policies be clarified and also that they should include a duty to defend on the part of the D&O insurer).

297. *See supra* notes 55-131 and accompanying text.

298. *See supra* notes 285-96 and accompanying text.

costs. The corporation should then be able to collect the amount it indemnified its executive from its D&O insurer.[299] If the executive's corporate employer is unable or unwilling to indemnify, the executive should be able to recover directly from the D&O insurer for the attorneys fees and other costs he paid.[300] If the executive secures a pretrial dismissal on procedural grounds of some of the charges, and seeks indemnification from the corporation, he is entitled to mandatory pro-rata indemnification for the dismissed charges only if the applicable indemnification statute requires reimbursement when one is "successful on the merits or otherwise."

If the executive negotiates a plea agreement and secures a dismissal of some of the charges in return for a plea of guilty to other charges, he is not entitled to mandatory reimbursement if the applicable statute requires that one be "wholly successful." He is entitled to any mandatory pro-rata reimbursement for the dismissed charges if the applicable law requires only that one be "successful."

If the executive has been partially successful on the criminal charges, (i.e. through pretrial motions to dismiss charges or a plea agreement dismissing some of the charges), but this measure of success is insufficient to qualify for mandatory indemnification, the executive may still receive indemnification by qualifying under statutory standards for permissive indemnification. Similarly, the executive who has been convicted on all criminal charges may receive indemnification by qualifying under these permissive standards.[301] Through the interplay of applicable principles of corporate, criminal and insurance law, a convicted executive may well qualify under these permissive standards.[302] However, even if the executive cannot qualify under the permissive standards, he may still receive indemnification under the incorporation statutes of the twenty states that allow a court to order indemnification even if the permissive standards are not met.[303] Also, an executive who is ultimately unable to meet the permissive standards may receive defacto indemnification in forty-nine states by receiving an advance of attorneys fees with no repayment required or, in some cases, even requested.[304] In the forty-eight states

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299. This collection would, of course, be subject to applicable limits and deductibles. For a discussion of limits and deductibles see J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.03 (1981 Supp. 1990); THE 1987 WYATT SURVEY, *supra* note 246, at 57, 75.

300. *See* sources cited *supra* note 299.

301. Such a result assumes that no other limitations apply. *See supra* notes 221-29 and accompanying text.

302. *See supra* notes 55-131 and accompanying text.

303. *See supra* notes 214-15 and accompanying text.

304. *See supra* notes 199-209 and accompanying text.

governed by a nonexclusive or quasi-nonexclusive incorporation statute, the executive may obtain indemnification from the corporation even if he fails to meet the statutory standards as long as corporate bylaws, resolutions, or a negotiated contract allow indemnification.[305] The only hurdle the convicted corporate executive must overcome in receiving indemnification through any of these routes is principles of public policy enforced by the courts. However, because of the small likelihood that an indemnification award will be reviewed by a court, and because courts erratically apply these principles of public policy, this is an unlikely impediment.[306]

If the convicted executive attempts to collect from the insurer for his fines, penalties and defense costs, or if the corporation attempts to collect from the insurer for amounts it indemnified the convicted executive, coverage is uncertain. D&O policies purport to exclude coverage of claims arising from criminal liability. However, because of ambiguity in the policy definitions and exclusions,[307] and because some policies grant coverage equal to a corporation's power to indemnify,[308] such claims may be covered.

B. ASSESSMENT AND PROPOSAL

Having surveyed this land of riches for convicted executives, the merits of such reimbursement must be evaluated. There are legitimate business reasons why corporations and insurers should be allowed to reimburse executives for costs these executives incur due to liability arising from their corporate duties. It is probably true, and it is certainly the perception, that corporate executives may be exposed to greater risks of liability than are most of us. With increasingly creative plaintiffs,[309]

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305. *See supra* notes 143-45 and accompanying text.

306. *See supra* notes 159-98 and accompanying text.

307. *See supra* notes 275-84 and accompanying text.

308. *See, e.g.*, Stewart Smith Form, in J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, app. 8A, at 51 (1981 & Supp. 1990).

309. Lynch, *RICO: The Crime of Being A Criminal, Parts I & II*, 87 COLUM. L. REV. 661 (1987) (and cases cited at 661 n.3); Note, *The Civil Rico Pattern Requirement: Continuity and Relationship, A Fatal Attraction*?, 56 FORDHAM L. REV. 955, 960 n.37 (1988) (private plaintiffs are finding more creative uses for the RICO statute). *See, e.g.*, Fleet Management Systems, Inc. v. Archer-Daniels-Midland Co., 627 F. Supp. 550 (C.D. Ill. 1986) (licensor of computer software program filed action against licensee alleging violation of RICO Act when licensee participated in a scheme to fraudulently misappropriate and market the licensed software); Grogan v. Platt, 835 F.2d 844 (11th Cir. 1988), *cert. denied*, ___U.S. ___, 109 S. Ct. 531, 102 L. Ed. 2d 562 (1988) (federal agents and estates of two other agents involved in a shootout with criminal suspects filed a complaint against the estates of the suspects seeking damages under civil provisions of the RICO Act).

a financial market riddled with scandals,[310] and courts rendering unpredictable verdicts,[311] these risks may even be rising. In today's business environment, some degree of indemnification is undoubtedly necessary to attract and retain talented and capable executives. Moreover, executives cannot be burdened with layers of bureaucracy installed solely to protect them against frivolous lawsuits. The fear of litigation cannot be allowed to cripple our innovative executives who can, and should, be able to act quickly and intuitively before promising business opportunities vanish.[312] To the extent indemnification and D&O insurance provide this freedom, they should be encouraged. However, reimbursement to convicted executives is a different matter. It should not be allowed to continue unchecked because we fail to acknowledge its true girth or because we fail to comprehend the unique policy interests it tramples.

An analogy may help demonstrate why indemnification to convicted executives should not be allowed. We would not be concerned if the family of a convicted bank robber paid the expenses of his defense and the fine imposed upon him. Indeed, most of us would probably approve of such familial support at a time of stress and need. The difference between our bank robber and the corporate executive, however, is in who is paying and the threat such payment poses to our legal system. If the bank robber's "family" was a gang that recruited individuals to be bank robbers and to share their ill-gotten gains with the organization, reimbursement of fines, penalties and expenses by the gang after a gang-member's conviction would strengthen this organization's influence on its remaining members. It is not difficult to see that if an organization is able, by money, to partially neutralize the sanctions of society, the organization's values have a better chance of superseding those of society. When the members of the organization see payments to their fallen comrade, they cannot help but believe that wealth and status within the organization are worth the risks (now neutralized, at least somewhat, by money) of robbing banks.

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310. Labaton, *'Junk Bond' Leader is Indicted by U.S. in Criminal Action*, N.Y. Times, Mar. 30, 1989, §I, at 1, col 6 (Michael Milken faces 98 counts and forfeitures of $1.8 billion for cheating clients and stockholders, manipulating the marketplace, and deceiving a corporation about to be taken over); Nash, *S.E.C. is Under Fire in Letting Boesky Sell Off Holdings*, N.Y. Times, Nov. 21, 1986, §I, at 1, col. 1, ("[T]he first class action suit was filed against Mr. Boesky, seeking damages for his insider trading . . . Lawyers expect to see an avalanche of claims against Mr. Boesky and companies and individuals involved with him."); Wayne, *Wall St. Saw a Tough 'ARB,'* N.Y. Times, Nov. 22, 1986, §I, at 41, col. 3 (Ivan F. Boesky pays a record $100 million fine for illegal insider trading).

311. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

312. Stone, *Enterprise Liability*, *supra* note 8, 90 YALE L.J. at 47; Note, *Evaluating the New Director Exculpation Statutes*, 73 CORNELL L. REV. 786, 806 (1988).

The analogy of a gang of bank robbers to a corporation is faulty in two respects, both of which provide further insight as to why we should not indemnify convicted executives. First, robbing banks is clearly a crime and it would take alot of indoctrination to overcome society's stigma of it as criminal. Often, however, corporate crime is not clearly criminal; it is "puffing" a little too much about the value of assets, or speculating too optimistically about profits, or compromising on technical regulations to meet a deadline. Corporate crime is also "hidden within an organization"[313] and, because it may take the independent acts of many people to actually complete the criminal conduct, its criminal character is often subtle. Since corporate crime is not as obvious of a crime as is bank robbery and does not fit our traditional notion of a crime, it is also not as hard to convince otherwise respectable people to engage in it. In short, a corporate organization has a better chance of instilling its values in its members than does a bank-robbing gang.

The second flaw in our analogy to bank robbers is the respective impact on society of bank robbers and corporate criminals. Bank robbers are not good for any of us, but their immediate damage is confined to a particular bank and its employees or customers. Their long term harm to the security of our savings system is dwarfed, however, by the harm caused by white collar crime.[314] Whether we are talking about our savings system, political infrastructure, environment, health care system, defense industry, or pension system, the damage caused by white collar crime debilitates the foundation of our society.[315] Because of this impact, there

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313. *White Collar Crime Hearing*, *supra* note 62, at 103 (1986) (testimony of Professor Stanton Wheeler, Yale Law School); *cf.* D. Timmer & D. Eitzen, Crime in the Streets and Crime in the Suites 248-255 (1989); K. Mann, Defending White Collar Crime 8-13 (1985); J. Coleman, The Criminal Elite 212-217 (1985); F. Lee Bailey & H. Rothblatt, Defending Business and White Collar Crimes 2-3 (1984); M. Clinard & P. Yeager, Corporate Crime 6-7 (1980).

314. In 1982, the estimated loss due to bank robberies, burglaries and larcenies was $45 million. Daniels, *Crimes Against Financial Institutions Decline During Second Half of 1982*, 16 Fed. Home Loan Bank Bd. J. 20, 22 (1983). By comparison, estimates of the loss due to fraud and embezzlement in the banking industry was $401.5 million for the same time period. *Id.* Current estimates of the amount that will be lost because of fraud and mismanagement in the Savings and Loan industry is $200 billion. Rosenbaum, *S&L's: Big Money, Little Outcry*, N.Y. Times, Mar. 18, 1990, § 4, at 1, col. 1.

315. *See, e.g.*, J. Coleman, The Criminal Elite 1-3 (1985) ("[Street crime's] image has become so bloated in the mirror of public opinion that it blocks our view of the white collar crimes which are both more costly and more dangerous to society."); E. Sutherland, White Collar Crime: The Uncut Version 8-9 (1983) ("The financial cost of white collar crime is probably several times as great as the financial cost of all the crimes which are customarily regarded as the 'crime problem.'"); M. Clinard & P. Yeager, Corporate Crime 8-9 (1980) ("[Corporate crimes] involve not only large financial losses but also injuries, deaths, and health hazards. They also involve the incredible costs

is a greater societal need to control our many corporations than our few bank-robbing gangs.

There can be no question that because of the increasingly significant role corporations assume in modern society, it is essential that they encourage lawful, rather than unlawful, behavior. They have the power to do either. To examine this, all one has to do is turn to the wealth of business literature on corporate culture which examines how a particular corporate environment can encourage, or discourage, behavior.[316] For criminal justice purposes, some of the most interesting work on corporate culture has been conducted by sociologists who have examined the commission of corporate crime to determine the characteristics of lawful and unlawful organizations. These scholars suggest that certain social structures and processes internal to an organization encourage unlawful behavior.[317]

For example, in a study of sixty-four retired, middle management employees of Fortune 500 corporations,[318] Marshall Clinard found that these executives consistently identified corporate internal structure (versus outside market forces) as primarily determinative of whether a corporation was lawful or unlawful.[319] One such internal factor was top management's attitude toward applicable laws and regulations.[320] Top management who encouraged law abiding behavior were described as respectful of appli-

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of the damage done to the physical environment and the great social costs of the erosion of the moral base of society. Such crimes destroy public confidence in business and in the capitalist system as a whole, and they seriously hurt the public image of the corporations themselves and their competitors."); A. Bequai, White Collar Crime: A 20th Century Crisis 2-4 (1978) ("Victims [of white collar crime] range from the average, unsuspecting consumer to the sophisticated banker; both young and old are open to attack. No individual or institution is immune to white collar criminals."); J. Conklin, Illegal But Not Criminal 4-5 (1977) ("Violations of the law by businessmen not only cost money; they may also lead to physical harm or even death.").

316. *See, e.g.*, D. Graves, Corporate Culture-Diagnosis and Change (1986); T.E. Deal & A.A. Kennedy, Corporate Cultures (1982); T.J. Peters & R.H. Waterman, In Search of Excellence: Lessons From America's Best Run Company (1982); A. Sampson, The Seven Sisters (1975).

317. M. B. Clinard, Corporate Ethics and Crime 122 (1983); Fisse, *Reconstructing Corporate Criminal Law: Delerance, Retribution, Fault & Sanctions*, 56 S. Cal. L. Rev. 1141, 1163 n.96 (1983); Vaughan, *Toward Understanding Unlawful Organizational Behavior*, 80 Mich. L. Rev. 1377, 1378 (1982).

318. M. B. Clinard, Corporate Ethics and Crime, *supra* note 317, at 24-25.

319. *Id.* at 132. It should be noted that Clinard focused this study on unethical as well as unlawful behavior. *Id.* at 35. When studying illegal behavior, such co-mingling may be problematic but it seems appropriate given the lack of legal training of the managers in Clinard's sample. As one executive stated: "[l]aw violations are about the same as ethics except in the former you go to jail." *Id.* at 132.

320. *Id.* at 132

cable government regulations, encouraging of their enforcement, and effective in monitoring their compliance by employees.[321] Another significant internal factor was the pressure placed on middle management to show a profit. Companies that encouraged unlawful behavior communicated to their employees that compromises in following the law were permitted if necessary to meet the profit goal.[322] Indemnification of executives convicted of violating the law cannot help but communicate this.

Diane Vaughan's study of Revco Inc. is especially interesting as a case study of organizational crime.[323] In 1977, Revco Inc., a pharmaceutical retailer, pled guilty to submitting over $500,000 in false medicaid claims.[324] Drawing upon this case study Vaughan focuses, in part, on the relationship between corporate structural factors and unlawful behavior.[325] She concludes that the "organizational processes . . . create an internal moral and intellectual world" in which "individuals within the organization are encouraged to engage in unlawful behavior."[326] These organizational processes include reward mechanisms, internal education and training, and informational processing and recording methods.[327]

In short, there is no question that the formal and informal structure of a corporation can encourage or discourage violations of the law. Indemnification by a corporation or reimbursement by an D&O insurer to an executive who has been convicted of crimes is part of this structure. By paying a convicted corporate executive for fines, penalties and costs incurred in his criminal case, and often by doing so after explicitly finding that this executive acted in good faith and had no reason to believe his conduct was unlawful, corporations and insurers are sending a message to corporate executives. They are telling these employees that pursuit of corporate goals justifies breaking the law and that they will reward those who do so. Moreover, this indemnification separates corporate executives from other criminal defendants. With someone else paying their litigation expenses and fines or penalties, corporate executives do not feel the pain or stigma of a criminal verdict and sentence as do other criminal defendants. Thus, indemnification and insurance not only contribute to a corporate culture that encourages corporate crime but also perpetuate two levels of justice.

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321. *Id.* at 74, 132.
322. *Id.* at 91, 140-44.
323. D. Vaughan, Controlling Unlawful Organizational Behavior (1983).
324. *Id.* at 17.
325. *Id.* at 68.
326. *Id.* at 70.
327. *Id.* at 68-77.

When one examines the historical evolution of indemnification and D&O insurance, one can see how their potential for encouraging corporate crime was overlooked. These methods of reimbursement developed in the context of civil law,[328] the traditional objective of which is reimbursement to a victim by the party causing the injury.[329] Indemnification and insurance further this goal because they assist the party found liable in paying the judgment to the victim. Notably, even when indemnification does not further this goal, as when the civil defendant has sufficient assets to pay the judgment, indemnification still does not detract from it.

By comparison, the major objective of criminal liability is deterrence.[330] Our criminal justice system is based upon the belief that by public condemnation, sufficiently harsh penalties and loss of privileges, a defendant and all others who observe his conviction and sentence will be discouraged from engaging in the proscribed behavior. Indemnification and D&O insurance never serve this goal of deterrence; rather, they allow a private party (either a corporation or an insurer) to neutralize, if not defeat it.[331]

While this proffered explanation may help explain our current practice of indemnifying convicted executives, it cannot justify it. We cannot continue to ignore the very different impact indemnification and D&O insurance have in the civil and criminal arenas. Reimbursement through indemnification and D&O insurance to convicted executives should not

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328. *See supra* notes 3-5.

329. Hart, The Concept of Laws 157 (1961) (Hart refers to the civil law as "conceived as offering redress for harm" whereas the criminal law is "conceived not only as restricting liberty but as providing protection from various sorts of harm."). *See, e.g.*, J. Hall, General Principles of Common Law 188-214 (1947); Mueller, *Mens Rea and the Corporation*, 19 U. Pitt. L. Rev. 21, 37, 38 (1957). For a fascinating discussion of how punitive damages interface civil tort law and criminal law, see *Symposium: Punitive Damages*, 40 Ala. L. Rev. 687 (1989).

330. This is the utilitarian theory of punishment. A discussion of it may be found in J. Bentham, An Introduction to the Principles of Morals and Legislation, ch. 16, in Bowring, The Works of Jeremy Bentham (1962); *see also* American Law Institute, Comments on Model Penal Code § 2.07, at 148 (Tent. Draft No. 4) (1956) ("It would seem that the ultimate justification of corporate criminal responsibility must rest in large measure on an evaluation of the deterrent effects of corporate fines on the conduct of corporate agents."). Some would disagree that this should be the reason for criminal punishment arguing that criminal punishment should not be imposed because of the consequences it will have on future behavior but because an individual acted immorally. Kant sets forth the classic argument for this position. I. Kant, The Metaphysical Elements of Justice 99-107 (Bobbs-Merrill ed. 1965).

The positions are not incompatible. Some commentators suggest that both goals should be served by criminal punishment. *See, e.g.*, Hart, *The Aims of the Criminal Law*, 23 Law & Contemp. Probs. 401, 422-425 (1958).

331. Stone, *Enterprise Liability*, *supra* note 8, 90 Yale L.J. at 48, 55.

be allowed.[332] Indemnification statutes should be amended so that they directly and plainly exclude indemnification to any convicted executive. The nonexclusivity provision in these statutes should also be amended so that corporations cannot circumvent such a prohibition by indemnifying convicted executives through bylaws, resolutions, or contracts. To the extent that the definition of "loss" or the dishonesty exclusion in D&O policies obligates insurers to reimburse convicted executives or corporations that have indemnified convicted executives, these polices should be redrafted to clearly exclude such coverage.

Advances of fees to executives who are targets of a criminal investigation or who have been charged but not yet acquitted or convicted, presents a more complex question than does that posed by reimbursement to convicted executives for fines and penalties. Currently every state incorporation code, except that of Vermont, gives corporations the power to advance attorneys fees before there has been a judgment.[333] Four reasons can be offered in favor of allowing these advances.

The first reason is based upon fundamental fairness and the need to attract qualified executives. Every person is presumed innocent until found guilty. By refusing to advance funds, corporations and insurers are presuming guilt or at the least, questioning innocence. Because of the increased, and perhaps increasing, risks to which corporate executives are exposed, the fair assurance that advances of fees will be provided if the need arises may be necessary to attract capable and talented executives.

The second reason in favor of advancing fees is the one propounded by most commentators,[334] and in a related situation, by the Supreme Court.[335] It is that because attorneys fees are so large, an advance is necessary for the executive to wage a vigorous defense. The importance of this interest is viewed by these scholars to outweigh the "minimal"

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332. Some statutes and agencies already attempt to prohibit such reimbursement. *See, e.g.*, Investment Companies and Advisers, 15 U.S.C. § 80a-17(h) (Supp. 1990) (prohibits "any provision which protects . . . any director or officers of [a registered investment company] against . . . willful misfeasance, bad faith, gross negligence or reckless disregard of . . . duties"); Foreign Corrupt Practices Act, 15 U.S.C. § 78ff(c)(3) (Supp. 1990) (prohibits indemnification of criminal fines owed for violations of the FCPA); 17 C.F.R. § 230.461(c) (1990) (the SEC requires corporate executives to waive their right to indemnification for personal liability for the corporation to qualify for acceleration of the effective date of a registration statement). *Cf.* Stone, *Enterprise Liability*, *supra* note 8, 90 Yale L.J. at 55-56.

333. *See supra* note 199.

334. *See, e.g.*, Note, *Insurance For Executives*, *supra* note 8, 80 Harv. L. Rev. at 660; Note, *Indemnification of Directors*, *supra* note 4, 76 Harv. L. Rev. at 1411.

335. Comm'r v. Tellier, 383 U.S. 687, 694-95, 86 S. Ct. 1118, 1122-23, 16 L. Ed. 2d 185, 190-191 (1966).

deterrence achieved of not advancing funds.[336] There can be no doubt that the attorneys fees incurred by corporate executives in defense of criminal charges may be large: as noted, the 1988 Wyatt Survey found the average attorneys fees in cases involving corporate executives to be $693,000.[337] There are two flaws, however, in using this argument to justify advances; both stem from a failure to look at who will be receiving the advance. Most corporate executives are relatively wealthy.[338] Of all people defending themselves against criminal charges, corporate executives probably need financial assistance the least. Also, it seems fair to suggest, most corporate executives are articulate, intelligent, and assertive people who are concerned about their reputations. These are the type of people who will wage a vigorous defense without having to be encouraged to do so. Thus, while superficially appealing, advancing fees so as to encourage a vigorous defense is of minimal relevance when we recognize that the people receiving the advances are unusually wealthy and determined defendants.

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336. Note, *Insurance for Executives*, *supra* note 8, 80 HARV. L. REV. at 661; *see also* Note, *Indemnification for Directors*, *supra* note 4, 76 HARV. L. REV. at 1411-12.

The deterrence argument is that an executive who knows she must pay her own attorneys fees will be deterred from committing criminal acts *and* that this deterrence is additional to any deterrence achieved by the executive's knowledge that she will suffer other penalties imposed because of a criminal conviction (fines, loss of job and damage to reputation). This deterrence argument has merit if the defense attorneys fees habitually dwarf the fine imposed (i.e., $495,000 in attorneys fees and a $1000 fine). One must concede, however, that this balance would be unusual and unpredictable. Although the "package" of tangibles (indemnification for all costs, fines, penalties, and retention of corporate rank, privileges, salary & benefits) and intangibles (emotional support from colleagues) offered to a convicted colleague by a corporation or insurer may effectively dilute the deterrence effect of the criminal law, an advance of fees is such an unusual portion of this package, it is of little consequence.

337. THE 1988 WYATT SURVEY, *supra* note 246, at 15.

338. The estimated median annual salary of top executives was around $34,000 in 1986 and many earned well over $52,000. *Bureau of Labor Statistics, U.S. Dept. of Labor, Bulletin 2300 Occupational Outlook Handbook* (1988-89). Most salaried executives in the private sector receive additional compensation in the form of bonuses, stock awards, and cash equivalent fringe benefits. *Id.* In addition to salary, the average director makes $50,000 a year for each outside board on which he serves and roughly $35,000 of this amount is cash. Krusekopf, *Pushing Corporate Boards to be Better*, FORTUNE, July 18, 1988, at 58. Most companies also offer a few hidden benefits, the most valuable of which is retirement pay. *Id.* This often amounts to $25,000 a year for life. *Id.* The number of directorships held by an individual serves to multiply these benefits. The mean number of directorships held by individuals in 1988 was 3.1. HEIDRICK AND STRUGGLES, THE CHANGING BOARD 13 (1988). The percentage of directors holding four or more directorships in 1988 was 31.7. *Id.*

To the extent a corporate executive should be indigent, or become indigent during the legal proceedings, appointment of counsel would be required by the sixth amendment to the United States Constitution. *See generally* Bucy, *Corporate Ethos: Reformulating Corporate Criminal Liability*, 75 MINN. L. REV. ____(1991).

The third reason for allowing advances for attorneys fees, at least from the perspective of the corporate employers and D&O insurers, is that the result in the criminal case may adversely affect civil lawsuits against the corporation or the insurer.[339] For example, if the executive refuses to enter into a plea agreement and pursues an aggressive defense which entails a lengthy and notorious trial, potential civil plaintiffs may gather information from the criminal trial which they can use in obtaining judgments in related civil cases against other corporate executives or the corporation, and for which the D&O insurer may be liable.[340] By advancing attorneys fees, however, the corporation or the D&O insurer may be able to influence the course of the criminal case in a way that best serves their interests, as for example, by encouraging a guilty plea instead of a protracted and public defense. Although many corporate executives may eagerly, or unknowingly, enter into this Faustian bargain to obtain advanced payment for attorneys fees, it has a corrupting influence on our system of justice. Not only is a convicted defendant avoiding, at least in part, the burden of a criminal conviction when someone else pays her fees, but she may also deprive the crime's victims of a collateral estoppel effect otherwise available as well as jeopardize her rights to a fair trial. We would be naive to ignore the fact that this potential collateral estoppel effect on related civil cases may be the major reason corporations and D&O insurers advance monies for fees.

The fourth argument proffered in favor of allowing corporations to advance attorneys fees is that mechanisms exist to protect the public,

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339. The doctrine of "collateral estoppel," a concept developed by the courts, becomes relevant here. It provides that an issue of ultimate fact that has been actually litigated in one judicial proceeding cannot be relitigated in another judicial proceeding. Ashe v. Swenson, 397 U.S. 436, 90 S. Ct. 1189, 25 L. Ed. 2d 469 (1970). Originally, courts required "mutuality of parties" before collateral estoppel could apply; that is, the parties in the first, and collateral, lawsuits had to be the same. When mutuality of parties is required, a conviction for fraud in a criminal case will be of limited applicability in a subsequent civil law suit alleging the same fraud. Although the defendant in each action will be the same, only when the government is bringing both the civil and criminal cases will the plaintiff be the same in both actions. When the plaintiffs in the collateral civil lawsuit are private citizens the mutuality of the parties requirement would prevent these citizens from using collateral estoppel in their civil lawsuit. In recent years the federal courts and many state courts have dispensed with the mutuality of parties requirement. Coffee, *No Soul to Damn*, *supra* note 8, 79 MICH. L. REV. at 442-44.

When collateral estoppel is applicable, a shareholder suing the corporate directors may be able to prevail on a motion for summary judgment in his civil lawsuit by reference to the conviction handed down in the criminal lawsuit. The D&O insurer may then become liable on these related civil judgments.

340. J. COLEMAN, THE CRIMINAL ELITE 166-169 (1985) ("The nolo plea deprives the victims of white collar criminals of the benefit of using the government's investigatory efforts, in civil cases.").

and shareholders, against improper and imprudent advances. Arguably, there are three such mechanisms. First, there is the requirement, in at least some states, that the executive seeking an advance furnish a written statement of his good faith belief that he meets the standard for permissive indemnification.[341] Second, there is a requirement, again in some states, that before an advance can be paid a determination must be made that "the facts then known" would not preclude indemnification under the incorporation statute.[342] Third, every state requires that the executive provide an "undertaking to repay" before receiving the advance.[343] The problem is that these protections are inadequate to ensure that improper advances will not be made. As noted, the good faith affirmation is pro forma only; virtually no one will admit anything but good faith early in a criminal case.[344] The requirement of a "determination" is not much better; the "determination" of facts is made by friendly parties using overly broad standards, and upon inadequate information.[345]

Ostensibly, the undertaking to repay provides more viable protection. Yet, it too is inadequate. The following scenario may help demonstrate why. We will assume that an advance is granted to an indicted executive. As her trial progresses, it becomes clear that this executive committed egregious acts of thievery and deceit upon the shareholders and public. She is convicted. Under no reasonable interpretation of any incorporation statute, bylaw, resolution, or contract can one say that this executive exhibited sufficient good faith to qualify for indemnification. Yet, our executive does not repay the advance; in this way she has received defacto indemnification, at least thus far.

There are two things that must occur before our executive's advance is recovered and she is prevented from obtaining defacto indemnification for her attorneys fees. The first is that the corporation, or insurer, must initiate the recovery of the advance. The second is that the corporation, or insurer, must be able to recover the advance.

One may safely assume that the insurer would fulfill both conditions in most situations. Unlike the corporation, which may have emotional or other loyalties to its executive, the insurer would have no incentive not to seek recovery. Also, unlike the corporation, which paid the advance directly to the executive and must now seek recovery of it from the recently convicted executive herself, most of the time[346] the insurer reimbursed the corporation which had already indemnified the executive.

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341. *See supra* statutes at notes 206 and 11.
342. *See supra* statutes at notes 207 and 11.
343. *See supra* statutes at notes 199 and 11.
344. *See supra* text at notes 207-09.
345. *See supra* text at notes 207-10.
346. The 1982 Wyatt Survey, *supra* note 242, at 61.

Thus the D&O insurer must simply collect the funds which were paid to the corporation. Assuming the corporation is solvent, generally it will be easier for an insurer to recover monies from a corporation than it is for a corporation to recover monies from a convicted executive.[347]

Whether a corporation will initiate or be able to recover an advance of funds paid to its executive, is a different matter. A corporation may not seek recovery of advances despite the egregiousness of the executive's actions because the remaining corporate executives are loyal to their convicted colleague or her family. More cynically, these executives may fear that their colleague will start pointing fingers at them unless she feels beholden to them, which she may if the corporation allows her to keep the funds advanced. For whatever reason, if the corporation is unwilling to seek recovery, there is a smorgasbord of loopholes by which the corporate executives may legally justify not doing so.

Even if the corporation decides to seek recovery of the funds advanced, however, it may be unable to find assets available. Perhaps anticipating a guilty verdict, wealthy executives may secret their assets or legally transfer title in them. Or, it is possible that during the years it may have taken the criminal case to run its course, the executive's wealth has been dissipated through over-leveraging or other financial misfortunes. This brings us back to the ineffectual nature of the "undertaking to repay" requirement. Without security, this undertaking to repay is worthless and confers defacto indemnification to executives who may have egregiously and blatantly committed crimes.

Sorting out the merits of allowing advances of attorneys fees is now easier. It is not only fair and equitable, but probably necessary to attract quality individuals, that these advances be available to corporate executives. This consideration is more powerful than the one typically suggested, that advances are necessary to encourage and facilitate a vigorous defense. Granted, a few executives may be able to wage a more vigorous defense if an advance is available but given the assets, personality, and reputation at stake of most executives, this rationale is relatively insignificant. On the other hand, the opportunity to influence an indicted or targeted executive's decisions in the criminal case is probably the main reason insurers and corporations prefer to make advances. Given

347. The circumstances in which a D&O insurer would have difficulty recovering an advance include occasions when the insurer made the advance directly to the executive and executive has no locatable assets; when the insurer has reimbursed the corporation for an advance it made to its executive, and the corporation refuses to repay the advance. A corporation may refuse to repay an advance to its D&O insurer if it has no assets itself, or if it asserts that the executive is entitled to the advance under applicable state law. The latter position, of course, could not occur if indemnification to convicted executives is categorically disallowed.

the hazards this influence poses to potential civil plaintiffs, and perhaps even to the executive herself, however, this reason militates against advances, at least from a public policy point of view. Lastly, the protections against imprudent advances already in the incorporation statutes cannot serve as an argument in favor of allowing advances because these protections are inadequate.

The previous proposal, that incorporation statutes be amended to categorically disallow indemnification to a convicted executive, should encourage a corporation to seek recovery of funds it advanced to an executive who now stands convicted of crimes. If this change is made, there would be no loopholes through which a corporation could dodge its obligation to seek recovery of advances. The ability to actually recover the monies advanced presents a separate problem, however. Before they are given an advance, which is in effect an interest-free loan, executives should be required to commit to a meaningful undertaking to repay; in other words, they should have to post security.[348] There should also be mechanisms for exempting those executives who truly are unable to post security, but need advances. Qualifying for this exemption could be handled in several possible ways, such as a blanket exemption for all outside directors representing charitable or consumer groups, or an exemption granted by a court after an ex parte review of the executive's financial statement.

Requiring security in all but appropriate exceptions recognizes the importance of providing corporate executives with advances to pay attorneys fees without doing so at the expense of the public interest. With the requirement of security the corporate executive is assured of sufficient money to hire able counsel, while shareholders are assured that they will not be left with the bill for the attorneys fees if the executive is ultimately convicted. More importantly, the public is assured that the goals and integrity of the criminal justice system cannot be flouted by private parties.

The last proposal for change pertains to the standards for mandatory indemnification in state incorporation statutes. Unlike the other avenues for reimbursement to convicted executives discussed herein, the statutory standards for mandatory indemnification are too restrictive. By failing to account for the practicalities of the criminal justice system, these standards can lead to bizarre and unfair results. Use of the "wholly successful" and "successful on the merits or otherwise" standards, while perhaps well-intentioned, delegate decisions with tremendous personal

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348. At least one court has apparently required such security before allowing an advance. Professional Ins. Co. of New York v. Barry, 60 Misc. 2d 424, 303 N.Y.S.2d 556, 561 (N.Y. Sup. 1969).

and policy ramifications to the unbridled discretion of one prosecutor. Because of the "wholly successful" language, executives who have been vindicated on serious and substantial charges but convicted on minor charges are not entitled to mandatory indemnification pro-rated to cover the charges on which they were successful. Because of the "successful on the merits or otherwise" language, executives who have secured a dismissal of criminal charges on procedural grounds but reek of bad faith and illegal intentions are entitled to full indemnification. A better approach to mandatory indemnification would be to require that the court before whom the criminal proceeding is pending determine whether the interests of justice are served by allowing indemnification to the executive who has been successful, in whole or part, on the criminal charges. Because the condition precedent to the court's exercise of such power is some form of success by the executive on at least some of the criminal charges, the court's discretion is considerably limited. Because the only court eligible to make this determination is the court before whom the criminal matter is pending, there is little danger of the manipulation and duplication posed by the provision in some statutes that allows courts other than the one familiar with proceedings to authorize indemnification.

Appendix A contains a proposed indemnification statute that incorporates all of the legislative reforms suggested herein.

IV. Conclusion

Because of the interplay of incorporation statutes, criminal law, and insurance law, corporations have broad discretion to indemnify their corporate executives who have been convicted of crimes. Because of ambiguity in D&O insurance policies and the courts' erratic application of principles of public policy, it is possible that insurers will be held liable for costs incurred by a convicted executive. One cannot assume that corporations or insurers will protest strongly about this. Corporate executives often want to indemnify their convicted colleagues. Moreover, due to the potential collateral estoppel effect of an executive's conviction on the future civil liability of the corporation, on other corporate executives and on the D&O insurer, these sources may be quite willing to indemnify the convicted corporate executive. Lost in the shuffle is the public's interest in fairness and the deterrence of corporate crime.

The compensatory goal of civil liability is well served by indemnification. This is the context in which corporate indemnification and D&O insurance developed and most commonly exists. With little analysis of public policy concerns, however, these sources of reimbursement have been extended to the criminal arena whose goal of deterrence is undercut by reimbursement to a convicted executive. Modifications in incorporation

statutes and D&O insurance policies such as those suggested herein are needed to insure that indemnification continues to serve the appropriate needs for which it was designed, yet not frustrate the goals and integrity of our criminal justice system.

APPENDIX A:

*PROPOSED INDEMNIFICATION STATUTE**

I. *DEFINITIONS*: In this Subchapter:

(A) "Corporation" includes any domestic or foreign predecessor entity of a corporation in a merger or other transaction in which the predecessor's existence ceased upon consummation of the transaction.

(B) "Person" means any individual who is or was a director, officer, employee or agent of the corporation or who is or was serving at the request of the corporation as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, employee benefit plan or other enterprise.

(C) "Expenses" include counsel fees.

(D) "Liability" means the obligation to pay a judgment, settlement, penalty, fine (including an excise tax assessed with respect to a proceeding).

(E) "Party" includes an individual who was, is, or is threatened to be made a named defendant or respondent in a proceeding.

(F) "Proceeding" means any threatened, pending, or completed action, suit, or proceeding, whether civil, administrative, criminal or investigative and whether formal or informal.

II. *AUTHORITY TO INDEMNIFY*

(A) Except as provided in subsection (D), a corporation may indemnify any person who was or is a party to any threatened, pending, or completed action, suit, or proceeding or investigation, whether civil or administrative against liability incurred in the proceeding if:

(1) the person acted in good faith; and

(2) the person reasonably believed:

(i) in the case of conduct in his official capacity with the corporation, that his conduct was in the corporation's best interests; and

(ii) in all other cases, that his conduct was at least not opposed to the best interest of the corporation.

(B) A person's conduct with respect to an employee benefit plan for a purpose he reasonably believed to be in the interests

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* Developed from the Revised Model Business Corporation Act, §§ 7.50-8.58 (1984) and The Delaware General Corporation Law, Del. Code Ann. tit. 8, § 145 (1983 & Supp. 1988).

of the participants in and beneficiaries of the plan is conduct that satisfies the requirement of subsection (A)(2)(ii).

(C) The termination of a proceeding by judgment, order, settlement, or its equivalent is not, of itself, determinative that the person did not meet the standard of conduct described in this section.

(D) A corporation may not indemnify a person under this section:

(1) in connection with a proceeding by or in the right of the corporation in which the person was adjudged liable to the corporation;

(2) in connection with any other proceeding charging improper personal benefit to the person, whether or not involving action in an official capacity, in which the person was adjudged liable on the basis that he improperly received a personal benefit; or

(3) in connection with a criminal proceeding as to all changes on which the person was convicted.

(E) Indemnification permitted under this section in connection with a proceeding by or in the right of the corporation is limited to reasonable expenses incurred in connection with the proceeding.

III. *MANDATORY INDEMNIFICATION*

(A) Subject to subsection (B), a corporation shall indemnify a person who was successful, on the merits or otherwise, in the defense of any proceeding including civil, administrative, or criminal, against reasonable expenses incurred by the person in connection with the proceeding.

(B) The court before whom the proceeding was pending must certify that the interests of justice are served by indemnification, in whole or part, to the person who has been successful, on the merits or otherwise, in the defense of the proceeding.

IV. *ADVANCE FOR EXPENSES*

(A) A corporation may pay for or reimburse the reasonable expenses incurred by a person who is a party to a proceeding in advance of final disposition of the proceeding if:

(1) the person furnishes the corporation with a written affirmation of his good faith belief that he has met the standard of conduct described in section II;

(2) the person furnishes the corporation a written undertaking, executed personally or on his behalf, to repay the advance if it is ultimately determined that he did not meet the standard of conduct; and

(3) a determination is made that the facts then known to those making the determination would not preclude indemnification under this subchapter.

(B) The undertaking required by subsection (A)(2) must be secured unless the court before whom the proceeding is pending determines that:

(1) the person is serving solely as the representative of a charitable or educational, not-for-profit, organization; or,

(2) after an ex-parte, incamera review of the person's financial status, the ends of justice are not served by the requirement of security.

(C) Determinations and authorizations of payments under this section shall be made in the manner specified in section VI.

V. *COURT-ORDERED INDEMNIFICATION*

A person who is a party to a proceeding may apply for indemnification to the court conducting the proceeding. On receipt of an application, the court after giving any notice the court considers necessary, may order indemnification if it determines:

(1) the person is entitled to mandatory indemnification under section III, in which case the court shall also order the corporation to pay the person's reasonable expenses incurred to obtain court-ordered indemnification; or

(2) the person is entitled to permissive indemnification under section II.

VI. *DETERMINATION AND AUTHORIZATION OF INDEMNIFICATION*

(A) A corporation may not indemnify a person under this subchapter unless authorized in the specific case after a determination has been made that indemnification of the person is permissible in the circumstances because he has met the standard of conduct set forth in sections II or III.

(B) The determination shall be made:

(1) by the board of directors by majority vote of a quorum consisting of directors not at the time parties to the proceeding;

(2) if a quorum cannot be obtained under subsection (1), by majority vote of a committee duly designated by the board of directors (in which designation directors who are parties may not participate), consisting solely of two or more directors not at the time parties to the proceeding;

(3) if a quorum cannot be obtained under subsection (1) or a committee cannot be obtained under subsection (2), by special legal counsel:
  (i) selected by the board of directors or its committee in the manner prescribed in subsection (B)(1); or
  (ii) if a quorum of the board of directors cannot be obtained under subsection (B)(1), selected by the court before whom the proceeding is pending.

(4) by the shareholders, but shares owned by or voted under the control of directors who are at the time parties to the proceeding may not be voted on the determination.

(C) Authorization of indemnification and evaluation as to reasonableness of expenses shall be made in the same manner as the determination that indemnification is permissible or mandatory, except that if the determination is made by special legal counsel, authorization of indemnification and evaluation as to reasonableness of expenses shall be made by those entitled under subsection (B)(3) to select counsel.

VII. *INSURANCE*

(A) *Insurance for Civil Liability*

A corporation may purchase and maintain insurance on behalf of a person against civil or administrative liability asserted against or incurred by said person arising from his status as a director, officer, employee, or agent, whether or not the corporation would have power to indemnify him against the same liability under section II or III.

(B) *Insurance for Criminal Liability*

A corporation may purchase and maintain insurance on behalf of a person against criminal liability asserted against him arising from his status as a director, officer, employee, or agent; however, no corporation may maintain said insurance that would have the effect of reimbursing criminal fines or penalties.

VIII. *APPLICATION OF SUBCHAPTER*

(A) A corporation shall have the power to make any other or further indemnification of any of its directors, officers, employees, or agents under any bylaw, agreement, vote of shareholders or disinterested directors, or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office except no corporation may indemnify an executive against liability incurred because of gross negligence, willful misconduct or criminal conduct.

(B) This subchapter does not limit a corporation's power to pay or reimburse expenses incurred by any person in connection with his appearance as a witness in a proceeding at a time when he has not been named as a defendant or respondent in a civil proceeding, or as a defendant or grand jury target or grand jury subject in a criminal proceeding or investigation.

Loss Causation: Exposing a Fraud on Securities Law Jurisprudence

Michael J. Kaufman*

I. Introduction

After creating the idea of "loss causation"[1] in federal securities law cases, the federal courts have called the concept "ungainly,"[2] "exotic,"[3] "confusing,"[4] and even "unhappy."[5] One federal court has recognized that the full application of "loss causation" to civil actions filed under Securities and Exchange Commission Rule 10b-5[6] would entirely "eviscerate" that primary antifraud provision.[7] Still, the federal courts have uniformly concluded or assumed that loss causation is an element of a private right of action for damages under Rule 10b-5.[8]

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1. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

2. LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931 (7th Cir.), *cert. denied*, 488 U.S. 926 (1988).

3. Bastian v. Petren Resources Corp., 892 F.2d 680, 685 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

4. *LHLC*, 842 F.2d at 931.

5. *Bastian*, 892 F.2d at 685.

6. 17 C.F.R. § 240.10b-5 (1990). Rule 10b-5 was promulgated by the Securities and Exchange Commission pursuant to its authority under § 10(b) of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78a-7811 (1988).

7. Rankow v. First Chicago Corp., 870 F.2d 356, 367 (7th Cir. 1989) ("Under the district court's theory, any intervening change in market conditions not directly caused by the defendant could break the chain of causation and exempt the defendant from liability, a result that would eviscerate Rule 10b-5.").

8. *See, e.g.*, Bruschi v. Brown, 876 F.2d 1526, 1530-31 (11th Cir. 1989); Currie v. Cayman Resources Corp., 835 F.2d 780, 785 (11th Cir. 1988); Kademian v. Ladish Co., 792 F.2d 614, 628 (7th Cir. 1986); Harris v. Union Elec. Co., 787 F.2d 355, 366-67 (8th Cir.) (suggesting that both transaction and loss causation can be inferred from the materiality of the nondisclosures), *cert. denied*, 479 U.S. 823 (1986); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 773 (9th Cir. 1984) (loss causation not an issue when "evil" is in the inducement to invest); Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943-44 (2d Cir.) (transaction causation necessary but not sufficient; loss causation must also be shown), *cert. denied*, 469 U.S. 884 (1984); Sharp v. Coopers & Lybrand, 649 F.2d 175, 186 n.16 (3d Cir. 1981) (referring to the "ubiquitous requirement that losses be causally related to the defendant's wrongful acts"), *cert. denied*, 455 U.S. 938 (1982); Huddleston v. Herman & MacLean, 640 F.2d 534, 549-50 (5th Cir. Unit A Mar. 1981), *cert. granted*, 456 U.S. 914 (1982), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

The confusion generated by "loss causation" is due in part to its evolving definition. In *Schlick v. Penn-Dixie Cement Corp.*,[9] the court defined "loss causation" as a "showing" that a defendant's misrepresentations or omissions in connection with a securities transaction "caused the economic harm," but emphasized that such a showing could "rather easily" be made by any proof of injury.[10] In his influential dissent in *Marbury Management, Inc. v. Kohn*,[11] Judge Meskill viewed "loss causation" as a species of "proximate cause," and opined that the loss complained of in a securities fraud case must "proceed *directly* and proximately from the violation claimed and not be attributable to some supervening cause."[12] Judge Meskill further defined "loss causation" as the requirement that a "single, direct causal chain run uninterrupted from the alleged violation through a securities transaction to a demonstrable injury."[13] In *Huddleston v. Herman & Maclean*,[14] the Fifth Circuit echoed Judge Meskill's view that an investor must show that the "untruth" is "in some reasonably direct, or proximate, way responsible for his loss."[15]

The notion that a Rule 10b-5 plaintiff must show that the defendant's conduct caused his losses is unremarkable.[16] Yet, *Huddleston's* language goes farther. The court declared: "The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value."[17] Under this formulation of loss causation, the federal courts have begun to require plaintiffs to

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9. 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

10. *Id.* at 380.

11. 629 F.2d 705 (2d Cir. 1980).

12. *Id.* at 719 (Meskill, J., dissenting) (citing Piper v. Chris-Craft Indus. Inc., 430 U.S. 1, 51 (1977) (Blackmun, J., concurring) (emphasis in original)).

13. *Id.* at 720 (Meskill, J., dissenting).

14. 640 F.2d 534 (5th Cir. Unit A Mar. 1981), *cert. granted*, 456 U.S. 914 (1982), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

15. *Id.* at 549.

16. *But see* Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 Tex. L. Rev. 469 (1988). Professor Merritt argues that, in appropriate cases, the courts should award 10b-5 plaintiffs damages for "general market losses" when defendants are unable to "carry the burden of proving that their misrepresentations did not touch in any way upon the reasons for the plaintiff's loss." *Id.* at 471. He would also "allow plaintiffs to recover damages even for unrelated market losses if they can show that the misrepresentations induced them to purchase a security that they otherwise would not have chosen at any price." *Id.* Although Professor Merritt's article is an excellent first-step in understanding how the courts have treated the issue of loss causation, it does not address the question of what "loss" is recoverable in a securities fraud action. This Article, by contrast, begins with this fundamental question and only then attempts to resolve the issue of causation.

17. *Huddleston*, 640 F.2d at 549.

prove that the misrepresentation caused *all* of the investment's decline in value before they can recover *any* loss at all.[18] This is remarkable.

In tracking the evolution of these various formulations of loss causation, Part I of this Article shows that this concept is now being used by courts to deny plaintiffs *any* damages when they cannot prove that the defendant's conduct caused *all* of their losses. Part II contends that the arguments advanced in favor of loss causation, based on the statutory scheme underlying the federal securities laws, United States Supreme Court causation decisions, the common law, and public policy, do not support the view that securities fraud plaintiffs must show that the defendant's conduct caused the full decline in the value of their investments before they can recover any damages.

This Article, in Part III, then suggests that loss causation be abandoned in securities fraud actions. To the extent the concept requires plaintiffs to prove the defendant's conduct caused a loss measured at the time of the transaction, it states an obvious damages principle. To the extent it requires, in addition, plaintiffs to prove that the defendant's fraud caused the full posttransaction decline in value of the securities purchased as a condition to any recovery, it states the wrong damages principle.

Loss causation, therefore, should be replaced in securities law jurisprudence with a plain definition of recoverable loss, one that recognizes that the ultimate posttransaction decline in the value of an investment is relevant in a securities fraud action only to the extent that it provides evidence of the recoverable loss, a loss which occurs and is fixed only at the time of the transaction. In Part IV, this Article concludes by showing that this definition easily can be applied in securities fraud cases, and actually reconciles the apparent conflicts among them created by the loss causation confusion.

II. The Evolution of Loss Causation

A. *Causation Established by Proof of Actual Reliance*

In *List v. Fashion Park, Inc.*,[19] the federal courts first addressed the issue of causation in Rule 10b-5 actions. Recognizing the "confusion" among the parties regarding this issue, the court concluded that the

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18. *See, e.g.*, Bastian v. Petren Resources Corp., 892 F.2d 680, 684-85 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

19. 340 F.2d 457 (2d Cir.) (affirming not clearly erroneous district court findings that a shareholder alleging fraud could not prevail because he would have sold even if he had known that an insider had purchased stock and the company resolved to negotiate a merger), *cert. denied sub nom.* List v. Lerner, 382 U.S. 811 (1965).

causal link between the fraud and the harm could be shown by proof that the plaintiff actually relied on the defendant's conduct. The test of reliance is whether "the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss."[20] According to the court, it is this reliance requirement that provides the vital function in certifying that "the conduct of the defendant actually caused the plaintiff's injury."[21]

In the wake of *List*, a plaintiff could establish causation in a securities case by proving reliance. When plaintiffs proved that they, in fact, had relied upon material misrepresentations in an offering circular, the Second Circuit confronted for the first time the argument that plaintiffs "must prove not only that the misleading statement caused them to purchase . . . stock but that the statement caused their economic loss by directly affecting the market price of [the] stock."[22] The Second Circuit initially rejected that argument, approving a jury instruction that made no distinction between reliance and loss causation.[23] The instruction required the plaintiff to prove that "he or she suffered damages as a proximate result of the alleged misleading statements and purchase of stock in reliance to them."[24] The jury was permitted to find both reliance and loss causation from evidence that the eventual loss was "a reasonably foreseeable result of the misleading statement."[25] Because, however, the plaintiffs' only proof on the issue of causation was their actual reliance on the misleading statements, the court effectively collapsed the distinction between loss causation and reliance. The central issue in securities fraud cases became whether the plaintiffs could prove actual reliance.

B. Schlick: *Causation Separated From Reliance*

It is in that context that the Second Circuit in *Schlick v. Penn-Dixie Cement Corp.*[26] first employed the term "loss causation." Although *Schlick* has been called the "most influential opinion employing this terminology,"[27] the case actually stresses the relative insignificance of loss causation. Schlick, a minority shareholder of Continental Steel Corporation ("Continental") alleged that Penn-Dixie Cement Corporation ("Penn-Dixie") made material misrepresentations and omissions in

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20. *Id.* at 462 (citing RESTATEMENT OF TORTS § 546 (1936)).
21. *Id.*
22. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).
23. *Id.* at 1291.
24. *Id.*
25. *Id.* at 1276.
26. 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).
27. Merritt, *supra* note 16, at 471 n.5.

its proxy materials in order to reduce the market price of Continental stock and thereafter to effectuate a merger with Continental at an exchange ratio less favorable to Schlick than it would have been absent the misrepresentations. There was no doubt in the case that Schlick had properly alleged loss causation — that the "misrepresentations or omissions caused the economic harm."[28] The court concluded that loss causation is "demonstrated rather easily by proof of some form of economic damage."[29] The "unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed," according to the Court, "easily" satisfied the requirement of loss causation.[30]

The difficult issue in the case instead was whether Schlick had properly alleged "transaction causation" — that Penn-Dixie's proxy fraud caused Schlick, a minority shareholder, to enter into the merger transaction. The court declared that transaction causation typically "requires substantially more" than does loss causation.[31] Transaction causation was a particularly difficult issue because the transaction was approved by a majority of Continental shareholders. Further, the minority shareholder had not, and could not, allege that he had actually relied on the misrepresentations in question in deciding whether to enter into the merger transaction. Nor did the case involve omissions, the materiality of which could be used to presume reliance.[32] Because the plaintiff alleged "market manipulation" and a merger on preferential terms, however, the court concluded that even in this context independent proof of transaction causation was unnecessary.[33] The court thus separated transaction causation from loss causation only to demonstrate that, in that case, proof of transaction causation was as easy as that of loss causation.

C. *After* Schlick: *Transaction Causation Becomes "Rather Easily" Shown*

Although *Schlick* was written to remove from the plaintiffs the burden of proving transaction causation, it has been read to impose upon plaintiffs the burden of proving loss causation. Since *Schlick*, it is transaction causation that has become "rather easily" proven, and loss causation that has required "substantially more."[34] In *Schlick* itself,

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28. *Schlick*, 507 F.2d at 380.
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.* at 381.
34. *Id.* at 380. In *Schlick*, of course, it was the reverse: loss causation was "rather easily" established and transaction causation required "substantially more."

the court suggested that the issue of transaction causation was indistinguishable from "reliance, materiality and the buyer-seller requirement."[35] The court further recognized that in Rule 10b-5 cases involving either material nondisclosures or market manipulation, the plaintiff need not show reliance.[36] But in a misrepresentation case, the plaintiff must establish transaction causation by proof that "he relied on the misrepresentations in question when he entered into the transaction which caused him harm."[37]

The evolution of the fraud on the market theory[38] and the collapse of the distinction between misrepresentations and omissions, however, have slowly removed from the plaintiff the burden of proving reliance or transaction causation even in misrepresentation cases. Under the fraud on the market theory, courts began to permit plaintiffs[39] to establish reliance or transaction causation from mere proof that the defendant made a material misrepresentation "into an impersonal, well-developed market for securities. . . ."[40] The federal courts also started recognizing that a material misrepresentation is nothing other than the failure to disclose a material fact that would make the representation not misleading.[41] One court defined a material misrepresentation as a "half-truth"; it is deceptive because of what it omits.[42] When the distinction between misrepresentation cases and omission cases is blurred, plaintiffs can establish reliance or transaction causation from materiality in both, indeed all, types of securities fraud actions.[43]

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35. *Id.* at 380 n.11.

36. *Id.* at 381.

37. *Id.* at 380.

38. As "[s]uccinctly put" by the Supreme Court, the "fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations." Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988) (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

39. The 1975 case of Blackie v. Barrack, 524 F.2d 891, 905-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), is the first reported appellate decision embracing the theory. The Second Circuit adopted the theory in Panzirer v. Wolf, 663 F.2d 365, 367-68 (2d Cir. 1981), *cert. denied*, 458 U.S. 1107 (1982).

40. *See Basic*, 485 U.S. at 247.

41. *See, e.g.*, Competitive Assocs., Inc. v. Laventhol Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975).

42. Flamm v. Eberstadt, 814 F.2d 1169, 1173 (7th Cir.), *cert. denied*, 484 U.S. 853 (1987).

43. *See, e.g.*, *Laventhol*, 516 F.2d at 814.

D. Huddleston: *Loss Causation Requires Substantially More*

When transaction causation or reliance became "rather easily" established from proof of the materiality of a misrepresentation or omission, courts grew concerned once again that plaintiffs might be able to recover damages without any showing of an actual link between their losses and the defendant's conduct.[44] In *Huddleston v. Herman & MacLean*,[45] this concern led the court to embrace loss causation.[46] After characterizing reliance as a subjective inquiry into whether the plaintiff actually based his investment decision on a misrepresentation or omission and characterizing materiality as an objective inquiry into whether the plaintiff reasonably based his investment decision on the misrepresentation or omission, the court concluded that "causation requires one further step in the analysis: even if the investor would not otherwise have acted, was the misrepresented fact a *proximate* cause of the loss?"[47] The court further stated that the Rule 10b-5 causation requirement is met "only if the misrepresentation touches upon the reasons for the investment's decline in value."[48]

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44. *See, e.g.*, Marbury Management, Inc. v. Kohn, 629 F.2d 705, 718 (2d Cir.) (Meskill, J., dissenting) (citing Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1292 (2d Cir. 1969) ("causation must be proved else defendants could be held liable to all the world"), *cert. denied*, 397 U.S. 913 (1970)), *cert. denied*, 449 U.S. 1011 (1980).

45. 640 F.2d 534 (5th Cir. Unit A Mar. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983).

46. *Huddleston* has been called the "leading case" in adopting loss causation. Merritt, *supra* note 16, at 478. Indeed, while *Schlick* first expressly distinguished loss causation from transaction causation, *Huddleston* first interposed loss causation as a significant evidentiary issue.

47. *Huddleston*, 640 F.2d at 549 (citing Herpich v. Wallace, 430 F.2d 792, 810 (5th Cir. 1970) (emphasis in original)).

48. *Id.* The phrase "touches upon" is taken from the United States Supreme Court's opinion in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971). In that case, however, Justice Douglas used the term "touching" as a metaphor to describe § 10(b)'s statutory requirement that the fraud be "in connection with" the purchase or sale of securities. *Id.* at 12-13. According to the Court, when the plaintiff establishes that he has "suffered an injury as a result of deceptive practices touching [his] sale of securities," he has established that the fraud was in connection with his sale of securities. *Id.* The issue in *Bankers Life* was not whether the plaintiff-corporation had suffered losses as a result of the defendants' fraudulent practices. Indeed, there was no dispute in that case that the defendants' scheme, under which the corporation received no consideration in return for its sale of $5 million worth of its securities, caused that corporation's pecuniary loss. *Id.* at 9-10. Rather, the issue addressed by the Court was whether defendants' alleged scheme was "in connection with" a securities transaction with the plaintiff, as opposed to in connection with "internal corporate mismanagement." *Id.* at 12. The Court reached its result despite its agreement that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." *Id.* When the conduct at least touches upon a securities transaction, the

The *Huddleston* decision itself however does not present an insuperable barrier to recovery for securities fraud. Plaintiffs must establish reliance, materiality, and loss causation, but the court allows reliance to be presumed from materiality.[49] Moreover, in its discussion of the damages available to the plaintiffs on remand, the court made clear that they could recover by showing that the defendant's misrepresentation or omission created a difference between the transaction price and the "real" value of the security at the time of the transaction.[50] The court assumed that the challenged misrepresentations regarding the cost of completing a Speedway were not the cause of the Speedway's bankruptcy and the "investment's decline in value." Nonetheless, the court remanded for a new trial, allowing plaintiffs to recover to the extent that they could show that the misrepresentation created a difference between the price they paid for their interests in the Speedway and the true value of those interests at the time of their transactions.[51] In application, the court allows plaintiffs to recover even when the misrepresentation does not touch upon the reasons for the investment's ultimate decline in value, so long as the misrepresentation creates a disparity between the purchase price and the true value of the securities at the time of the transaction.

E. *After* Huddleston: *Loss Causation Used to Deny All Recovery*

Courts have employed the definition of loss causation suggested by *Huddleston* as a tool for denying all recovery when the plaintiff could not show that the fraud "touche[d] upon the reasons for the investment's decline in value."[52] The Seventh Circuit's *Bastian v. Petren Resources Corp.*[53] opinion represents the heyday of this approach. There, plaintiffs who purchased oil and gas limited partnership interests brought a Rule 10b-5 action against the general partners and their attorneys. Plaintiffs claimed that if the private placement memorandum had disclosed that the general partners previously had been sued and had defaulted in loan

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Court suggests, such conduct falls within the ambit of § 10(b) "whatever might be available as a remedy under state law." *Id.* Whereas the *Bankers Life* opinion employs the touching metaphor to describe the requisite connection between conduct and a securities transaction, the *Huddleston* opinion uses that metaphor to suggest a new requirement that conduct cause an investment's decline.

49. *Huddleston*, 640 F.2d at 547-48.

50. *Id.* at 556.

51. *Id.*

52. *See, e.g.*, Currie v. Cayman Resources Corp., 835 F.2d 780, 785 (11th Cir. 1988) (quoting *Huddleston*, 640 F.2d at 549); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting).

53. 892 F.2d 680 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

payments in connection with other oil and gas limited partnerships,[54] they would not have invested. Noting that the plaintiffs had failed to allege that these omissions were "causally linked to the loss in value of plaintiffs' investments,"[55] the district court dismissed the complaint.[56]

In affirming the dismissal, the Seventh Circuit precisely delineated the flaw in plaintiffs' complaint: "They have alleged the cause of their entering into the transaction in which they lost money but not the cause of the transaction's turning out to be a losing one."[57] The court suggested, in the language of *Huddleston*, that the plaintiffs must show that the omissions caused the "investment's decline in value."[58] Unlike *Huddleston*, however, which remanded the action for trial on the issue of whether the defendants' conduct created a difference between the price and the value of the securities at the time of the transaction, the Seventh Circuit concluded that the oil and gas investors could recover no damages whatsoever. By this view of loss causation, even if plaintiffs can prove that the defendant's fraud caused them to pay too much for securities at the time of the transaction, they may nonetheless not recover any damages unless they can also prove that the fraud caused the posttransaction decline in the value of their investments. This can be an insuperable barrier to recovery.

III. The Arguments Supporting Loss Causation

In concluding that Rule 10b-5 plaintiffs must prove that the defendant's conduct caused their investment's decline in value, courts and commentators have relied upon: (1) analogies to the overall scheme of the federal securities laws; (2) inferences from Supreme Court causation decisions; (3) the model of the common law of torts, and (4) the threat of unlimited liability.[59] This section addresses each of these arguments, concluding that none of them supports a requirement that plaintiffs prove that defendant's conduct caused their investments to decline in value.

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54. *See* Bastian v. Petren Resources Corp., 681 F. Supp. 530, 532 (N.D. Ill. 1988), *aff'd*, 892 F.2d 680 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

55. *Bastian*, 681 F. Supp. at 533.

56. *Id.* at 535.

57. *Bastian*, 892 F.2d at 684.

58. *Huddleston*, 640 F.2d at 549.

59. *See, e.g.*, Marbury Management v. Kohn, Inc., 629 F.2d 705, 716-23 (2d Cir. 1980) (Meskill, J., dissenting) (raising each of these arguments in a strong dissent); Merritt, *supra* note 16, at 484-506 (arguing that neither the federal regulatory scheme nor the common law rejects recovery of "gross" losses even when no proximate cause shown).

A. Analogies To The Regulatory Scheme

The federal courts have inferred from section 10(b) the congressional intent to create a private right of action for damages.[60] Because the private right of action is the product of the "federal common law,"[61] so too are its elements. In developing the elements of the inferred 10b-5 private right of action, the federal courts have drawn guidance from the elements of the private rights of action that Congress has expressly created. None of the express rights of action, however, supports an inference that Congress would have intended to require plaintiffs to prove as a condition to any recovery under Rule 10b-5 that the decline in value of their investment was caused by the defendant's fraud.

The express antifraud rights of action in the 1933 Act[62] clearly do not require the plaintiffs to prove that the defendant's conduct caused their investments to decline in value. Section 11 of the 1933 Act expressly allows acquirers of securities offered pursuant to a registration statement containing a material misstatement or omission to obtain damages from the issuer, its officers, directors, and professionals.[63] Section 11(e) contains an elaborate damage formula that allows plaintiffs to recover the difference between the offering price and either the "value" of the security at the time of the suit or the price received if sold before suit.[64] Section 11, however, contains a proviso that states:

> *Provided*, [t]hat if the defendant proves that any portion of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.[65]

This proviso has been called a "proximate cause limit," which is "analogous to the loss causation concept . . . ."[66]

The proviso, however, does not suggest that even in section 11 cases the plaintiff is required to prove that the defendant's conduct caused the investment's decline in value. First, and most obviously, the proviso shifts to the defendant the burden of proving that the plaintiff's losses

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60. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988).
61. *Bastian*, 892 F.2d at 685.
62. 15 U.S.C. §§ 77a-77aa (1988).
63. *Id.* § 77k.
64. *Id.* § 77k(e).
65. *Id.* (emphasis in original).
66. Merritt, *supra* note 16, at 488.

were not caused by the defendant's material misstatements or omissions.[67] To the extent that Congress has recognized the concept of loss causation, it has placed the burden on the defendant to prove the absence of causation.

Second, the concept of loss causation recognized in section 11(e) allows defendants to limit their exposure to the amount by which their material misstatement or omission has altered the purchase price of the securities. Even if the proviso placed on the plaintiff the burden of proving that the decline in the value of the security resulted from the defendant's misrepresentation, the plaintiff could recover some amount of damages without proving that the defendant's conduct caused the full decline in the value of the securities.

Indeed when Congress has placed upon the plaintiffs the burden of proving causation, it has indicated that the burden may be discharged by proof that the defendant's conduct created a disparity between the price and the value of the securities at the time of the transaction. Section 9(e)[68] of the Securities Exchange Act of 1934 grants an express right of action against willful participants in the manipulation of securities prices for "damages sustained as a result of any such act or transaction" which affects the price at which the plaintiff purchases or sells a security.[69] The United States Supreme Court has suggested that the requisite link between conduct and loss under this section can be established by proof that the defendant's pretransaction conduct created a difference between the price and the value of the securities at the time of the transaction. In *Piper v. Chris-Craft Indus., Inc.*,[70] the Court concluded that in drafting this language in section 9(e), Congress "focused . . . upon the amount actually paid by an investor for stock that had been the subject of manipulative activity."[71] In that case, Chris-Craft, unsuccessful in its efforts to acquire control of Piper, filed suit against the target's management, its investment advisor, and its successor, Bangor Punta, alleging violations of section 14(e)[72] of the Exchange Act and SEC Rule 10b-6.[73] The Court relied upon section 9 in reaching its holding that Chris-Craft had no standing to sue under Rule 10b-6 absent allegations that the price it paid for the target's shares was altered by the defendants'

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67. Professor Merritt quickly points this out and astutely cites a host of cases in which the courts have placed on the defendant the burden of proving such causation. *See* Merritt, *supra* note 16, at 488.

68. 15 U.S.C. § 78i(e) (1988).

69. *Id.*

70. 430 U.S. 1 (1977).

71. *Id.* at 46.

72. 15 U.S.C. § 78n(e).

73. 17 C.F.R. § 240.10b-6 (1990).

conduct.[74] Because Chris-Craft sought only "compensation for its lost opportunity to control Piper,"[75] the Court concluded that it lacked standing to seek damages. Had Chris-Craft alleged that the defendants' conduct altered the price they paid for the target's shares, it presumably would have had standing to recover damages.

As Justice Blackmun's concurrence makes clear, the Court's analysis of the standing issue could well apply to the causation issue. In that concurrence, Justice Blackmun finds that Chris-Craft has standing, but concludes that it nonetheless should not be able to recover damages because its allegations fail to establish sufficient causation. The element of causation was missing because Chris-Craft had not even "suggested" that the "price which it paid for Piper shares was influenced" by defendants' manipulative conduct.[76] Justice Blackman made clear, however, that if Chris-Craft had sought damages from its overpayment for Piper shares, rather than damages for its lost opportunity to control Piper, proof that the defendants' conduct "influenced" the purchase price of Piper shares would have been sufficient to establish causation.[77] Federal courts interpreting section 9(e) since *Piper* have agreed that the link between conduct and loss is supplied by proof that the defendant's conduct created a difference between the price and the value of the securities traded, at the time of the transaction.[78]

Similarly, section 18[79] of the 1934 Act, which like section 9(e) expressly requires some showing of causation, does not require plaintiffs to prove that the defendant's conduct — materially misleading statements in reports filed pursuant to the 1934 Act[80] — caused the posttransaction decline in their investment's value. That section allows persons who buy or sell securities in "reliance" upon misleading statements and at a price "affected by" the misleading statement to recover "damages caused by such reliance."[81] Arguably, this provision requires plaintiffs to prove (1)

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74. The Court justified its reliance on § 9 because of its close relationship to Rule 10b-6 and because the SEC, in an amicus brief, had suggested that its authority to promulgate Rule 10b-6 derived from § 9 as well as from § 10. *See generally Piper*, 430 U.S. 1.

75. *Id.* at 46.

76. *Id.* at 52-53. The Court finds this point, which is referred to by the majority, "conclusive" on the issue of causation. *Id.*

77. *Id.* at 53.

78. *See, e.g.*, Crane v. American Standard, Inc., 603 F.2d 244, 253 (2d Cir. 1979) (section 9 requires more than a "generalized" showing of causation; causation shown from proof that conduct altered securities transaction price); Shull v. Dain, Kalman & Quarl, Inc., 561 F.2d 152 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978).

79. 15 U.S.C. § 78r (1988).

80. *Id.*

81. *Id.* § 78r(a).

reliance; (2) that the misleading statement affected the transaction price (transaction causation); and (3) that the defendant's conduct caused damages (loss causation). That the defendant's misleading statements caused the plaintiff's loss, however, can be proved from evidence that the plaintiff's reliance on the misleading statements induced him to trade at a price "affected" by the statements. Congress allows the recovery of "damages caused by such reliance," indicating that the loss recoverable under section 18 is the amount by which the transaction price was "affected by" the misleading statement relied upon. In a case in which reliance is established (or presumed), therefore, Congress allows the recovery of "damages" when the plaintiff shows that the defendant's misleading statement altered the plaintiff's transaction price. In both section 18 and section 9, Congress has indicated that the "loss" recoverable for misleading public statements and conduct that otherwise manipulates the price of a securities transaction, is the amount by which the defendant's conduct has affected the plaintiff's transaction price. In that context, the issue of causation becomes self-evident: plaintiffs must prove that the defendant's conduct altered the transaction price. There is no support in either section 9 or section 10 for the position that Congress intended damages to be recoverable only if plaintiffs could prove that the defendant's conduct caused the posttransaction decline in the value of their investments.

A fortiori, the remaining express rights of action, none of which suggest a causation element, do not support any requirement that plaintiffs prove defendant's conduct caused a posttransaction decline in their investment's value. Section 12(2) of the 1933 Act,[82] which creates a private right of action against any person who offers or sells a security through material misstatements or omissions,[83] allows successful plaintiffs to "recover the consideration paid for such a security with interest thereon less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."[84] This section is thought to create a "broad rescissionary measure of damages,"[85] and it allows defrauded buyers to recover damages without showing causation.[86] Indeed, the Supreme Court has observed that in section 12(2) "Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud."[87] According to the Court, the deterrent

82. *Id.* § 77l.
83. *Id.*
84. *Id.*
85. Merritt, *supra* note 16, at 491.
86. *See, e.g.*, Loss, Fundamentals of Securities Regulation 890 (1988).
87. Randall v. Loftsgaarden, 478 U.S. 647, 659 (1986).

purposes of that section would be "ill-served by a too rigid insistence on limiting plaintiffs to recovery of their 'net economic loss.'"[88]

Courts and scholars reason from the language of section 12(2) and those interpretations of it, that Congress did not intend to require plaintiffs to prove that the defendant's material misstatements or omissions caused their investments to decline in value.[89] That much is clear. What is less clear is whether Congress intended to require section 12(2) plaintiffs to prove that the defendant's misstatements or omissions caused their recoverable loss. The loss recoverable under section 12(2) is limited to the purchase price of the security.[90] Therefore, although the risk of posttransaction decline may, as a consequence, fall upon the defendant, that decline itself is simply irrelevant to section 12(2) recovery. Loss is measured only at the time of the transaction. Even in section 12(2), Congress consistently rendered posttransaction stock movements irrelevant to the issue of loss.

Moreover, although a successful 12(2) plaintiff can recover his or her full purchase price, that purchase price typically in a section 12(2) case reflects the materiality of the defendant's misrepresentations. Congress has presumed that in a typical section 12(2) case in which a seller of securities necessarily "solicits"[91] the sale by making material misstatements or omissions to the buyer, those misstatements or omissions will be so material as to induce the sale itself — not just the sale at a higher price. Accordingly, in section 12(2) Congress intended to limit the issue of causation to pretransaction conduct that creates a difference between the transaction price and the value of the securities at the time of the transaction.

Even in its express disgorgement remedies, Congress has refused to burden plaintiffs with showing that the defendant's conduct caused a fluctuation in the value of their investments. Section 16(b) of the 1934 Act allows a corporation to recover profits realized from the short-swing trading of its stock by its officers, directors, and ten-percent shareholders.[92] Similarly, newly-enacted Section 20A of the 1934 Act, allows

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88. *Id.* at 664 (citation omitted).

89. *See, e.g.*, Merritt, *supra* note 16, at 491-92.

90. The statute allows recovery of the "consideration paid" (or purchase price) plus interest, and less any income received. Interest is the equivalent of prejudgment interest, and the deduction for income received, of course, merely makes a wash of income gained. 15 U.S.C. § 77l(2) (1988).

91. In Pinter v. Dahl, 486 U.S. 622 (1988), the Supreme Court defined a "seller" under the identical language of § 12(1) of the 1934 Act as someone who "successfully solicits" the sale of securities to benefit himself or the title holder.

92. 15 U.S.C. § 78p(b) (1988).

persons who trade "contemporaneously" with one in possession of material non-public information to recover from the insider "the profit gained or loss avoided" in the transaction.[93] Both disgorgement remedies limit recovery to the profit realized as a result of the transactions.[94] In order to determine the profit realized from transactions made unlawful under section 16(b) or section 20A, the factfinder must, of course, analyze the performance of the security after the transaction has taken place. In both cases, the analysis requires comparing the defendant's initial purchase or sales with subsequent resales or repurchases. Yet, the objective of the analysis is always to determine whether and to what extent the defendant's conduct has created a difference between the price and the value of the securities at the time of the unlawful transaction.

The director, for example, who buys his corporation's stock at $100 per share without disclosing material, nonpublic merger information and sells the stock at $150 per share when, three months later, the merger is consummated, must under both section 16(b) and section 20A disgorge his profits. The defendant's profit results from two transactions, but only the first transaction was entered with material, nonpublic information. The profit realized from the second transaction is only *evidence* of the illegal profits from the initial transaction. Moreover, the profit realized from the second transaction is evidence of the degree to which the initial transaction price diverged from the value of the securities at the time of the initial transaction. The initial transaction price was $100 per share, but that price presumably would have been much higher if the defendant had disclosed the material, nonpublic information regarding the imminent merger.

The rise in price after disclosure is strong evidence of the effect that the defendant's omission had on the transaction price of the first transaction. The rise in market price, of course, is also the defendant's profit. Accordingly, the defendant's profit measures the disparity that the defendant's conduct has created between the price and the value of the securities traded. Not only do Congress's disgorgement remedies relieve plaintiffs of the burden of proving that the defendant's conduct caused the posttransaction decline in the value of their investment, but they reduce posttransaction price movements to evidence of the effect that the defendant's conduct had on the price of the transaction itself.

Finally, some courts and commentators have relied upon section 28 of the 1934 Act as support for requiring plaintiffs to prove that the

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93. *Id.* §§ 78t-1(a),(b).

94. Section 16(b) allows recovery of "any profit realized by him *from* any purchase and sale, or any sale and purchase" of a security within six months. *Id.* § 78p. Section 20A allows recovery of profit gained or loss avoided "in the transaction or transactions that are the subject of the violation." *Id.* § 78t-1(b).

defendant's conduct caused their investments to decline in value.[95] That section limits recovery under the 1934 Act provisions to "actual damages on account of the act complained of."[96] Professor Merritt demonstrates persuasively that the context, structure, policies, and judicial interpretations of this section do not preclude recovery of damages in excess of the "net economic harm suffered by the plaintiff."[97] Professor Merritt goes so far as to argue that section 28(a) allows plaintiffs to recover the full decline in the value of their investment ("gross economic loss") even if they are unable to show that the decline was caused by the acts challenged.[98] Regardless of whether that assertion is correct, section 28(a) certainly does not require plaintiffs to prove that the defendant's conduct caused the posttransaction decline in value of their securities as a condition to their recovering the difference between their transaction price and the value of their securities at the time of the transaction.

B. *Supreme Court Declarations on Causation in Securities Cases*

When the Supreme Court has addressed the issue of causation under the securities laws, it has done so primarily in the context of implied rather than express rights of action.[99] None of its opinions developing a federal common law of causation supports the position that plaintiffs must prove that the defendant's conduct caused their investments to decline in value.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[100] the Court concluded that because the plaintiff "suffered an injury as a result of deceptive practices touching its sale of securities as an investor," it had standing to pursue a section 10(b) action.[101] This lan-

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95. *See, e.g.*, Marbury Management, Inc. v. Kohn, 629 F.2d 705, 719 (2d Cir. 1980) (Meskill, J., dissenting); Merritt, *supra* note 16, at 485 n.76 (citing cases and commentary).

96. 15 U.S.C. § 78bb(a) (1988).

97. Merritt, *supra* note 16, at 485-87 (citing Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986)).

98. Merritt, *supra* note 16, at 476-77.

99. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988) (causation in the context of Rule 10b-5 materiality and fraud on the market concepts); Randall v. Loftsgaarden, 478 U.S. 647 (1986) (discussing causation in the context of § 12(2) and Rule 10b-5); Piper v. Chris-Craft Indus. Inc., 430 U.S. 1 (1977) (Blackmun, J., concurring) (addressing causation under the § 14(e) implied right of action for tender offer fraud); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (developing standards of causation under Rule 10b-5); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) (addressing causation in the context of § 10(b)'s "in connection with" requirement); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) (developing standards of causation under § 14(a)'s implied right of action for proxy fraud).

100. 404 U.S. 6 (1977).

101. *Id.* at 12-13.

guage suggests that standing hinges on the ability to allege injury caused by deceptive practices. But, in the context of the facts of *Bankers Life*, this language cannot be read to require plaintiffs to allege and prove that the defendant's fraud caused a posttransaction decline in the value of securities. First, the issue confronted by the Court was not whether the fraud caused the plaintiff-corporation's losses. Rather, the issue was whether the fraud was "in connection with" the purchase or sale of securities. In the context of defining that requirement, the Court declared that when the fraud involves a securities transaction, rather than just internal corporate management issues, the fraud is within the ambit of the federal securities laws.[102] The Court's focus, therefore, was not upon the relationship between the defendant's conduct and the plaintiff's losses.

Second, even if the Court's reasoning is strong enough to reach the issue of causation, that reasoning suggests that plaintiffs need only show a causal link between the defendant's conduct and losses suffered at the time of the transaction. In *Bankers Life*, the plaintiff corporation alleged that it was injured as a result of the defendant director's failure to disclose the material fact that it would effectively receive no consideration in return for its sale of $5,000,000 of United States Treasury Bonds.[103] The subsequent performance of the Bonds was simply irrelevant to the issue of whether the corporation had alleged a sufficient nexus between the defendant's conduct and the difference between the value of the securities sold and the price received.

Similarly, in *Affiliated Ute Citizens v. United States*,[104] the Court suggested that the element of causation in a section 10(b) action may be established by proof of conduct that creates a difference between the transaction price and the value of a security at the time of the transaction. The Court concluded that in section 10(b) cases involving primarily a duty to disclose, the materiality of the nondisclosure establishes the "requisite causation in fact."[105] The Court's characterization of "causation in fact" as "requisite" indicates its view that some degree of causation is a necessary element of a section 10(b) claim. Indeed, Justice Blackmun later declared that *Affiliated Ute* "did not abolish the requirement of causation" even in "failure-to-disclose cases."[106]

Yet, neither did *Affiliated Ute* suggest that in proving causation, plaintiffs must establish that the defendant's conduct caused a post-

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102. *Id.*

103. *Id.* at 9 ("[T]he seller was duped into believing that it, the seller, would receive the proceeds [of the sale].").

104. 406 U.S. 128 (1972).

105. *Id.* at 153-54.

106. Piper v. Chris-Craft Indus. Inc., 430 U.S. 1, 51 (1977) (Blackmun, J., concurring).

transaction decline in the value of their investments. In the case itself, a bank's transfer agents purchased securities from mixed-blood Ute Indians without disclosing to them the material fact that these securities could be resold on an active non-Indian market for substantially greater amounts.[107] In order to recover for the fraud, the plaintiffs need not show that the defendant's omissions caused the posttransaction increase in the value of the securities. Instead, the Court clearly stated that plaintiffs may recover "the difference" between their actual transaction price and what their transaction price would have been absent the fraudulent conduct.[108]

Recoverable loss is measured only at the time of the transaction. Accordingly, the issue of causation is necessarily limited to the defendant's effect on the transaction price. When plaintiffs show that the defendant's conduct created a difference between the transaction price and the value of the securities at the time of the transaction, they have established that the defendant's conduct caused their losses. When, as in *Affiliated Ute*, the defendant's conduct is the failure to disclose facts, plaintiffs may prove that such conduct caused their losses by showing that the concealed facts are material.

Since *Affiliated Ute*, the Supreme Court has made clear that plaintiffs may establish that their recoverable losses were caused by the defendant's conduct by proving that the defendant's misrepresentations or omissions were material. According to Justice Blackmun, the materiality of a nondisclosure provides the "causal link between the omission of material information and the shareholder's act of purchasing or selling stock."[109] When, as in section 10(b) actions, the act of buying or selling stock reflects the loss itself, the materiality of the nondisclosure provides the "causal link" between the defendant's unlawful conduct and that loss.

The Supreme Court's reasoning in *Randall v. Loftsgaarden*[110] also suggests the irrelevance of posttransaction fluctuations in the value of an investment to the issue of causation in a securities fraud action. In *Randall*, the Court ruled that tax benefits received by an investor in a tax shelter venture may not be offset against rescissory damages awarded in cases brought under section 12(2).[111] In reaching its holding, the Court agreed with arguments presented by amici[112] that tax benefits, because they accrue only in conjunction with taxes owed and other income

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107. *Affiliated Ute Citizens*, 406 U.S. at 151-52.

108. *Id.* at 155.

109. *Piper*, 430 U.S. at 51 (Blackmun, J., concurring).

110. 478 U.S. 647 (1986).

111. *Id.* at 662.

112. The United States and the Securities Exchange Commission both filed amicus briefs in the case.

generated by the investor, would not have been a benefit derived from the securities without the intervention of an independent transaction by the investor.[113] Tax benefits, accordingly, are not part of the fair value of all that the investor receives. The Court also found that tax benefits are not part of the fair value of the consideration paid by the investors: "[T]he consideration given by petitioners in exchange for their partnership interests took the form of money, not tax deductions, and the fact that [investors] received tax deductions from which they were able to derive tax benefits, therefore, cannot constitute a return of that consideration."[114] According to the Court's logic, tax benefits would have no impact upon the measure of loss, a measure that must be made at the time of the transactions. The difference between the fair value of all that the plaintiffs received and the fair value of their consideration at the time of the transaction would not reflect posttransaction tax benefits at all.[115]

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113. *Randall*, 478 U.S. at 662.

114. *Id.* at 660.

115. The Court's rationale for not including tax benefits in the calculation of damages, thus, is not based on their theoretical incompatibility with § 12(2)'s rescissory measure of damages. Indeed, pure rescission, which requires both parties to return to their pretransaction condition, may require an offset. Rather, the Court's holding is based upon the premise that tax benefits have no place in determining the fair value of securities or consideration. *See id.* at 663-64 (allowing tax benefit may insulate those committing fraud). Because the calculation of the difference between the fair value of securities and the fair value of consideration, exclusive of tax benefits, is equivalent to a quantification of the materiality of the misstatement or omission, *id.* at 664, the Court's judgment that tax benefits have no place in that calculation is a judgment that such benefits are not material to the purchase or sale of securities.

The Court's assertion that its position did not defy economic reality further supports this interpretation of its decision. *See id.* at 665-66 (tax benefit not separate asset acquired by purchase of share of limited partnership). The economic reality at the time the case was decided was that a primary motive for investing in limited partnerships was to realize tax benefits. *Id.* The Court even noted that some lower courts had held that investors may sue for securities fraud when the defendant misrepresented the tax benefits of the investment, finding that the existence of those benefits was material. *Id.* at 665 (citing Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982)).

The Court, however, rejected those cases and the so-called economic reality approach. First, the Court found no evidence that Congress considered tax benefits to be material when it drafted § 12(2). *Id.* Second, the Court rejected the notion that tax benefits are a separate asset that can be valued apart from the partnership interest. *Id.* Third, and most significantly, the Court recognized that the tax benefits are not liquid; they cannot be freely transferred from one person to another apart from the partnership interest. *Id.* at 665-66. It would be impossible, therefore, to attach a reasonable or objective market value to a tax benefit because each investor's benefits would be different in each taxable year. Because it is impossible to affix to tax benefits a distinct fair value, it is also

Finally, in *Basic Inc. v. Levinson*,[116] the Supreme Court clearly stated that plaintiffs may recover under section 10(b) without proving that the

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impossible to assess the significance of the benefits to the "reasonable" investor.

In other words, the materiality of statements or omissions about tax benefits is, as the Court suggested, impossible to assess in any given case. *Id.* at 664. That problem, however, could have been solved by finding that tax benefits are either always or never material. The issue the Court really had to decide, therefore, was whether tax benefits are always or never material; it could not have adopted a case-by-case approach. The Court decided that they were never material because not only is the materiality of tax benefits difficult to assess on a case-by-case basis, but the amount of damages, which would have to be calculated only if benefits were always material, is also difficult to compute. The Court, in fact, recognized the difficulty of calculating damages based upon the materiality of tax benefits when it recited the "formidable difficulties in predicting the ultimate treatment of the investor's claimed tax benefits . . . ." *Id.* at 665. The Court in *Randall*, therefore, authorized the lower courts to ignore tax benefits in their calculation of damages under § 12(2) not because it is consistent with a rescissionary measure of damages, but because tax benefits are immaterial as a matter of law.

In his concurrence, Justice Blackmun questioned whether tax benefits are, as the majority suggested, always immaterial. He agreed with the majority that tax benefits should not be considered in calculating "income" or "consideration" under § 12(2), or when rescission is the proper remedy under § 10(b). *Id.* at 667-68 (Blackmun, J., concurring). Nor did he question that the disparity between fair value received and relinquished is typically the proper measure of § 10(b) damages. *Id.* at 668 (Blackmun, J., concurring). Justice Blackmun concurred that the materiality of the misrepresentation is tantamount to the portion of the purchase price attributable to an asset never received. *Id.* at 669 (Blackmun, J., concurring).

Justice Blackmun observed, however, that in calculating the disparity between purchase price and fair value of what was received, all of the elements that go into the price of the tax shelter should be taken into account, including the value of the tax write-offs. *Id.* at 668 (Blackmun, J., concurring). Unlike the majority, Justice Blackmun believes that the "level of potential tax benefits" can be separately valued and quantified as a portion of the fair value which the securities buyer receives. *Id.* at 669 (Blackmun, J., concurring). An investor can be *materially* misled about the value of those tax benefits, as well as about the value of the underlying asset. In other words, Justice Blackmun found that tax benefits can be material in some cases. He wrote separately to observe that because tax benefits can be material in some cases, they deserve some consideration in the calculation of the fair value disparity.

Although the majority concluded that tax benefits are never material and the concurrence observed that they are sometimes material, the dissent perceived that they are always material in tax shelter investments. In his dissent, Justice Brennan concluded that the "inure" which purchasers receive from their investments should, under both § 12(2) and Rule 10b-5, be considered in calculating the disparity between fair value paid and fair value received. *Id.* at 672 (Brennan, J., dissenting). In support of his position, Justice Brennan asserted that economic reality dictates that "a major portion of what the investor bargains for and purchases in a tax shelter is the tax benefit." *Id.* According to Justice Brennan, because tax benefits are a "major" portion of the fair "value" that the investor receives, they are material and, therefore, should be considered in calculating the difference between the fair value of what the investor receives and the fair value of what the investor pays. *Id.* at 674 (Brennan, J., dissenting).

116. 485 U.S. 224 (1988).

defendant's conduct caused the posttransaction decline in the value of their investment. Justice Blackmun, writing for the Court,[117] indicated that in a Rule 10b-5 case, the "nexus" between the defendant's conduct and the plaintiff's "injury" is a "necessary" one.[118] But it is reliance that provides the "requisite causal connection between a defendant's misrepresentation and the plaintiff's injury."[119] The "causal connection" or the "necessary nexus" between the plaintiff's "injury" and the defendant's conduct can be established by proof of the materiality of the omissions in nondisclosure cases or the materiality of either misstatements or omissions in a fraud on the market case.[120]

In discussing how the presumption of reliance and causation may be rebutted, the Court ignores the posttransaction movements in the value of the security. The relevant causal "link" is that between the defendant's misrepresentation and "either the price received (or paid) by the plaintiff."[121] The "causal connection" may be "broken" only if the defendant shows that the transaction price was unaltered by the misrepresentation.[122] In other words, the causation that counts in Rule 10b-5 cases is the nexus between the defendant's conduct and the transaction price. When plaintiffs prove that omissions created a difference between that transaction price and the true value of the securities at the time of the transaction, they have established that the defendant's conduct caused their recoverable losses.[123]

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117. Because Justices Rehnquist, Scalia and Kennedy did not participate in the case, and Justices White and O'Connor dissented from this portion of the Court's opinion, Justice Blackmun writes for only four Justices.

118. *Basic*, 485 U.S. at 244.

119. *Id.* at 243.

120. The Court cites Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), for the former proposition and holds in *Basic* itself that material nondisclosures or misstatements on an active market create a rebuttable presumption of reliance. *Basic*, 485 U.S. at 244-45.

121. *Id.* at 248.

122. *Id.* at 248-49.

123. Footnote 28 in *Basic* suggests that the market price of *Basic* stock may have reflected the alleged nondisclosures "quickly" and then emphasizes that the Court's "decision today is not to be interpreted as addressing the proper measure of damages in litigation of this kind." *Id.* at 248 n.28. Despite its caution, the Court's footnote and its opinion do suggest the loss that is recoverable under § 10(b). *Id.* Its footnote would contain a nonsequitor if there were no connection between the hint that the market price may have quickly reflected the alleged nondisclosures and the proper measure of damages in the case. Indeed, when the plaintiff's transaction price fully reflects the alleged nondisclosure, no damages may be recovered. Conversely, when the alleged nondisclosure creates a disparity between the transaction price and the value of the securities, then damages may be recovered. Recoverable loss, therefore, is the difference that the defendant's conduct creates between the price and the value of securities traded. Because that loss is

The Supreme Court's treatment of the issue of causation in proxy and tender offer fraud cases further demonstrates the relative insignificance of posttransaction events. In *Mills v. Electric Auto-Lite Co.*, the Court concluded that the "causal relationship" between misrepresentations in proxy solicitation materials and the plaintiff's "injury" can be established by proof that the misrepresentations were material and that the "solicitation" was an "essential link in the accomplishment of a merger transaction."[124] The Court left open the question of whether causation could be shown between material misrepresentations in proxy materials and the consummation of a merger when management controls a sufficient number of shares to approve the transaction without the minority's votes.[125] As *Mills* suggests, the answer to this unresolved question of causation and to the question of causation under section 14(a) generally cannot be reached without reference to the recovery sought. Stating that "[m]onetary relief" will be a "possibility" to redress section 14(a) violations, the Court observed that when the loss sought is the difference between the actual merger price and the merger price absent the misrepresentation, that loss is obtainable by a showing that the misrepresentation was material.[126] When plaintiffs cannot establish "direct injury" as an ultimate consequence of the merger, they may nonetheless recover when the defendant's conduct adversely alters the terms of the merger accepted by the shareholders.[127] In either case, loss is measured at the time of the merger transaction, and causation is established when the plaintiffs prove that the defendant's conduct altered the terms of that transaction.

The Court's analysis of causation in section 14(e) tender offer fraud cases is consistent. In *Piper v. Chris-Craft Industries, Inc.*,[128] Justice Blackmun observed that causation is a "far more complex issue" in tender offer fraud cases than it is in section 10(b) cases. When, as in *Piper*, the plaintiff's alleged injury is the "failure to acquire control of

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fixed at the time of the transaction, posttransaction price movements or events are irrelevant to the issue of whether plaintiffs can show that the defendant's conduct caused their losses.

124. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1977). The action was brought under § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1988), and SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1990), for fraud in the solicitation of proxies.

125. *Mills*, 396 U.S. at 385 n.7. In granting certiorari from Sandberg v. Virginia Bankshares, 891 F.2d 1112 (4th Cir. 1989), *cert. granted in part*, 110 S. Ct. 1921 (1990), the Court appears ready to address this unresolved question. *Sandberg* held that "even when the minority's voting strength is insufficient to halt a merger," reliance is not an "element of causation in a Section 14(a) action." 891 F.2d at 1121.

126. *Mills*, 396 U.S. at 388.

127. *Id.*

128. 430 U.S. 1, 51 (1977) (Blackmun, J., concurring).

the target corporation," the plaintiff must prove that the defendant's conduct "altered" the outcome of the control contest.[129] With regard to shareholders of the target corporation, which the Court suggested had standing to recover damages under section 14(e),[130] causation is apparently far less complex. Upon the shareholders' claim that the defendant's fraud altered the price that they accepted for their shares, they may recover the difference between that transaction price and the true value of their shares at the time of the transaction. That loss is recoverable without any showing that the outcome of the control contest may have resulted in additional losses. Although the Supreme Court has recognized the difficult causation problems associated with proving that proxy or tender offer fraud resulted in eventual losses occasioned by the outcome of the control contest, it has never suggested, even in those contexts, that plaintiffs must confront those problems in recovering the difference between their transaction price and the value of their securities at the time of the transaction.

C. Causation In Common Law Fraud Cases

Courts have relied on the common law in support of requiring section 10(b) plaintiffs to prove, as a condition of recovery, that the defendant's conduct caused their losses.[131] Whether the elements of section 10(b) should mirror the elements of common law fraud is the subject of much debate.[132] The debate is irrelevant here. If, as the Supreme Court recently suggested, the federal securities laws are designed to "add to the protections provided investors by the common law,"[133] then courts developing a rule of section 10(b) causation should not be bound by common law principles of causation. Yet, even if the common

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129. *Id.* at 51.

130. *See id.* at 42 n.28 (leaving open the issue whether shareholder-offerees have standing to sue under § 14(e)).

131. *See, e.g.*, Bastian v. Petren Resources Corp., 892 F.2d 680, 684 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting).

132. *Compare* Basic Inc. v. Levinson, 485 U.S. 224, 244 n.22 (1988) ("Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law") (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975)) *and* Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983) (section 10(b) remedies designed to supplement the common law) *with* Chiarella v. United States, 445 U.S. 222, 228 (1980) ("[T]he duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them.'" (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976))).

133. *Basic*, 485 U.S. at 244 n.22.

law were an appropriate model for section 10(b), the common law model of causation does not require fraud victims to prove as a condition to recovery that the defendant's conduct caused a decline in the value of their investments.

Prosser and the Restatement of Torts are typically cited for the position that plaintiffs alleging fraud in connection with a stock transaction must prove that the misrepresentations or omissions caused their economic losses: "[I]f false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors in no way relate [sic] to the representation will not afford any basis for recovery."[134] Neither authority supports the position.

Prosser addresses the stock fraud scenario in the context of damages, not in the context of causation. The treatise actually states:

> Where, as is commonly the case, the defendant's actionable misrepresentation or non-disclosure induces a transaction that involves the transfer of something of value, courts normally resort to a general measure of damages often referred to as direct damages, and, in addition thereto, will allow such other damages as special or consequential damages as the plaintiff can prove.[135]

If the plaintiff seeks to recover as "loss" the difference between what he transferred and what he would have transferred absent the fraud, that loss is recoverable without regard to the subsequent performance of the stock. But, when, and only when, the plaintiff seeks in addition to recover consequential or special damages, plaintiff must show that subsequent decline in stock value was caused by the fraud. The stock fraud hypothetical is offered by Prosser only as an example of the unavailability of *consequential* damages in some cases. It does not, and of course could not, stand for the proposition that in order to recover "direct damages," plaintiffs must prove that the defendant's conduct caused their "consequential" damages.

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134. W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser and Keeton on Torts § 110, at 767 (5th ed. 1984) [hereinafter W. Keeton]. *See also* W. Prosser, The Handbook of the Law of Torts § 110, at 732 (4th ed. 1971), *quoted in Marbury Management*, 629 F.2d at 718. The Restatement (Second) of Torts contains a similar example: "[T]here is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition." *Marbury Management*, 629 F.2d at 719 (quoting Restatement (Second) of Torts § 549A (1976)).

135. W. Keeton, *supra* note 134, § 110, at 766.

Nor does the Restatement support that result. Like Prosser, the Restatement makes clear that the posttransaction decline in the value of stock not caused by the defendant's conduct cannot be recovered.[136] But, like Prosser, the Restatement also makes clear that the posttransaction decline in the value of stock is not the only recoverable loss in a fraud action. In its very next section, the Restatement states that the fraud victim may recover the "pecuniary loss to him of which the misrepresentation is the legal cause,"[137] and includes with that recoverable loss both the "difference between the value of what he has received in the transaction and its purchase price"[138] and additional "loss suffered otherwise as a consequence . . . ."[139] Plaintiffs may recover the difference between their purchase price and the value of the security at the time of the transaction without proving that the defendants caused the additional loss suffered otherwise as a consequence.[140]

The common law fraud cases from which this understanding of causation evolved are consistent in their views of loss and of causation. In *Waddell v. White*,[141] cited by Prosser and Keeton as primary authority for the unrecoverability of losses unrelated to the defendant's misrepresentation,[142] the court distinguishes between two types of recoverable losses.[143] The plaintiff, who proved that he had been fraudulently induced to sell his land to the defendants for an interest in their company, could clearly recover the loss he suffered by selling his land cheaper than he would have had he known the facts concealed.[144] If, in addition, however, the plaintiff wished to recover losses in the form of the posttransaction decline in the value of his investment, he could do so to the extent that those losses "reasonably resulted" from the defendant's conduct.[145]

The common law case of *Hotaling v. A.B. Leach & Co.*[146] is similar. That case has been specifically relied upon as support for requiring plaintiffs to prove defendant's conduct caused their posttransaction losses as a condition to their recovery of any damages under the securities

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136. RESTATEMENT (SECOND) OF TORTS § 548A (1976).

137. *Id.* § 549.

138. *Id.*

139. *Id.*

140. The leading common law authorities also clarify that even consequential damages may be recovered in a fraud action when the subsequent "events" are merely "reasonably foreseeable." W. KEETON, *supra* note 134, § 110, at 767. *See also* RESTATEMENT (SECOND) OF TORTS § 549 (1976).

141. 56 Ariz. 420, 108 P.2d 565 (1940).

142. W. KEETON, *supra* note 134, § 110, at 767 n.25.

143. *Waddell*, 56 Ariz. 420, 108 P.2d 565.

144. *Id.* at 436, 108 P.2d at 572.

145. *Id.*

146. 247 N.Y. 84, 159 N.E. 870 (1928).

laws.[147] The case, however, permits the defrauded plaintiffs to recover the difference between the price they paid for their bonds and the value of the bonds at the time of the transaction without any showing that the defendant's conduct caused any posttransaction decline in value of their investment.[148] If, but only if, plaintiffs wish to recover for additional losses in the form of the posttransaction decline in the value of their bonds, they must somehow link the fraud and those losses.[149] Even those losses could be recovered when the decline would not have occurred, or would not have been as marked, absent the misrepresentations or omissions.[150]

Although the common law allows recovery of the posttransaction decline in value in some cases, it does not require the plaintiff to prove that the defendant's conduct caused that decline as a prerequisite to recovering the difference between the transaction price and the true value at the time of the transaction.

D. *The Potential for Unlimited Exposure*

Courts imposing upon plaintiffs the burden of proving that the defendant's conduct caused their losses ultimately warn that the absence of such a requirement would give Rule 10b-5 a "limitless thrust,"[151] creating a "scheme of investors' insurance"[152] that would render defen-

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147. *See* Marbury Management, Inc. v. Kohn, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting).

148. *Hotaling*, 247 N.Y. at 91, 159 N.E. at 872.

149. *Id.* at 91, 159 N.E. at 873.

150. *Id.* Professor Merritt states that the common law does not preclude recovery of losses even when the plaintiff does not show causation. Merritt, *supra* note 16, at 496-97. As this Article demonstrates, however, the issue of causation cannot be separated from the loss that plaintiffs are seeking to redress. Professor Merritt perhaps unwittingly demonstrates that the common law allows recovery of the difference between the transaction price and the true value of the securities at the time of the transaction. It generally does not allow recovery of posttransaction declines absent a showing of foreseeability or linkage. The point of "loss causation" is that in order to recover loss in the form of price-value differences at the time of the transaction, plaintiffs must prove that the defendant's conduct caused the posttransaction decline in the value of their investment. There is no support whatsoever at common law for that position.

151. *Marbury Management*, 629 F.2d at 718 (Meskill, J., dissenting) (citing Titan Group, Inc. v. Fagen, 513 F.2d 234, 239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975)).

152. List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied sub nom.* List v. Lerner, 382 U.S. 811 (1965). *See also* Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. Unit A Mar. 1981) ("Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."), *cert. granted*, 456 U.S. 914 (1982), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

dants "liable to all the world."[153] The warning stems from two very different arguments, one based on expanding the class of plaintiffs ("the world") to which defendants might be liable, and the other based on insuring investors against stock decline by allowing them always to recover the initial cost of their investments. Neither argument has merit.

The element of causation in a Rule 10b-5 case does not affect the class of plaintiffs to whom persons who make material misstatements or omissions in connection with the purchase or sale of securities may be liable. The issue of which persons harmed by material misrepresentations or omissions may bring a Rule 10b-5 action is one of standing, not one of causation. In order to have standing to assert a Rule 10b-5 action, plaintiffs must have purchased or sold a security.[154] Moreover, in order to be liable under Rule 10b-5, defendants must at least have made a material misstatement or omission in connection with the plaintiff's purchase or sale of securities.[155] A material misrepresentation or omission is one that has a "substantial likelihood" of altering the "total mix" of information made available to the reasonable investor.[156] When the defendant's conduct has a substantial likelihood of altering the mix of information available to a reasonable investor, such conduct will have altered the price at which a reasonable investor purchased or sold securities.[157] Defendants who make material misrepresentations or omissions in connection with the plaintiff's purchase or sale of securities, therefore, will alter the price at which the plaintiff purchased or sold the securities. Liability runs to all defendants who make such material misrepresentations or omissions and only to the defendants who do so. Adding an independent element of causation will not reduce the number or kind of plaintiffs to whom defendants may be liable.

The absence of an independent causation element does not force defendants to insure investors against trading losses. A defendant who

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153. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1292 (2d Cir. 1969) ("causation must be proved else defendants would be liable to all the world"), *cert. denied*, 397 U.S. 913 (1970).

154. Blue Chip Stamps v. Manor Drug Store, 421 U.S. 723, 737 (1975).

155. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977) (breach of fiduciary duty absent material misrepresentation or omission insufficient to establish 10b-5 liability); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 9 (1971) (material misrepresentation or omission must be in connection with the purchase or sale of securities).

156. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988) (defining materiality for 10b-5 purposes).

157. I have previously shown that a material omission is one that alters the price at which a reasonable investor is willing to purchase or sell securities. *See, e.g.*, Kaufman, *The Uniform Rule of Liability Under the Federal Securities Laws: The Judicial Creation of a Comprehensive Scheme of Investor Insurance*, 63 TEMP. L. REV. 61, 63-64 (1990).

utters a material misstatement in connection with the purchase or sale of securities will be liable for the difference that his misstatement creates between the transaction price and the true value of the securities at the time of the transaction.[158] Because that recoverable loss is measured at the time of the transaction, any posttransaction decline in the value of securities is irrelevant to its recoverability. When posttransaction declines are irrelevant, so too is the issue of what caused them. Accordingly, whether an independent causation element exits is irrelevant to the loss traditionally recoverable under Rule 10b-5.

The only way in which Rule 10b-5 plaintiffs may recover their full transaction price is when they successfully obtain full rescissory damages. Under this theory of recovery, plaintiffs theoretically may recover their entire purchase price in return for the value of their investments at the time the fraud is discovered.[159] To the extent this measure of recovery allows plaintiffs to recover any posttransaction decline in the value of their securities that are not merely reflective of the differences between the transaction price and the true value of the securities at the time of the transaction,[160] the measure of recovery may be troublesome. But it

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158. The Supreme Court and the circuit courts agree that the plaintiffs may recover out-of-pocket damages. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972) (Douglas, J., concurring in part and dissenting in part) (proper measure of damages is difference between fair value seller received and fair value of what seller would have received absent fraudulent conduct). *See also* Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 443 (7th Cir. 1987) (damages must be based on comparison of transaction price and expected value of shares), *cert. dismissed*, 485 U.S. 901 (1988); Smoky Greenshaw Cotton Co. v. Merrill Lynch, Pierce, Fenner & Smith, 785 F.2d 1274, 1278 (5th Cir. 1986) (traditional measure of damages in 10b-5 action is out-of-pocket rule), *cert. denied*, 482 U.S. 928 (1987); Alna Capital Assocs. v. Wagner, 758 F.2d 562, 566 (11th Cir. 1985) (in securities fraud, out-of-pocket damages rule applies); Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982) (customary measure of damages in Rule 10b-5 cases is out-of-pocket rule); Sharp v. Coopers & Lybrand, 649 F.2d 175, 190 (3d Cir. 1981) (measure of damages is difference between what buyer paid for stock and what buyer would have paid absent fraud), *cert. denied*, 455 U.S. 938 (1982); Holmes v. Bateson, 583 F.2d 542, 562 (1st Cir. 1978) (measure of damages is difference between fair value of what seller received and fair value of what seller would have received absent fraud); Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8th Cir. 1977) (rescissionary damages appropriate; allow plaintiff to recover difference between purchase and resale price), *cert. denied*, 435 U.S. 951 (1978); Nickels v. Koehler Management Corp., 541 F.2d 611, 617 (6th Cir. 1976) (proper measure of damages is difference between value of property as represented and actual value at time of sale), *cert. denied*, 429 U.S. 1074 (1977); Blackie v. Barrack, 524 F.2d 891, 908-09 (9th Cir. 1975) (out-of-pocket loss is ordinary measure of damages in 10b-5 suit), *cert. denied*, 429 U.S. 816 (1976); Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971) (defrauded seller can recover not only difference between actual value and sale value, but added profits realized by buyer).

159. *See, e.g.*, Jordan v. Duff & Phelps, 815 F.2d 429, 440 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988).

160. In Section IV, this Article shows that rescissory damages are awarded *only* to

is that troublesome measure of recovery and not the absence of an independent causation requirement that has the potential for insuring investors against market declines.

To illustrate the need for an independent causation requirement lest Rule 10b-5 become an insurance plan for investors, the court in *Huddleston v. Herman & MacLean*[161] hypothesizes an investor who purchases stock in a shipping venture in reliance upon a material misrepresentation about the vessel's capacity. The vessel, which is the venture's only asset, later sinks "as a result of" a casualty unrelated to the misrepresentation itself, and the stock becomes worthless. The Court concludes that a factfinder may find that the investor relied upon the material misrepresentation in purchasing the stock, but that the material misrepresentation nonetheless did not "cause the loss."[162]

The hypothetical is persuasive. It seems to demonstrate the point that absent any requirement that the plaintiff prove that the defendant's conduct "caused the loss," the defendant would become an insurer against even the most unforeseeable casualties. But, what does the Court mean by "loss"? In this context, the "loss" could mean at least the following: (1) the loss of the vessel's crew and the damages associated with that loss; (2) the replacement cost of the sunken vessel; (3) the loss to the venture of expected profits from the vessel; (4) the loss of the shipping venture's sole asset; (5) the loss of the investor's expected profits from his investment in the shipping venture; (6) the loss of the full amount of the investor's consideration paid for the shipping venture investment; or (7) the loss of the amount of consideration paid by the investor for the investment that would not have been paid absent the misrepresentation regarding the vessel's capacity.

The first four types of loss are those suffered directly by the vessel's crew or the venture itself as a result of the casualty. No one would suggest that the ship's crew or even the venture could bring any Rule 10b-5 action against the misrepresenter of the vessel's capacity for these losses. The misrepresentation did not cause the vessel to sink. To the extent that the Court's point is that the misrepresenter cannot be liable to the crew or the venture for such losses, the point is self-evident.

The remaining types of losses are those suffered not by the ship's crew or the venture, but by investors in the venture. Because these investors necessarily purchased a "security" within the meaning of the

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the extent that they reflect the amount of the disparity created by the defendants' conduct between the transaction price and the true value of the securities at the time of the transaction.

161. 640 F.2d 534 (5th Cir. Unit A Mar. 1981), *cert. granted*, 456 U.S. 914 (1982), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

162. *Huddleston*, 640 F.2d at 549 n.25.

1934 Act, they purchased something other than a vessel.[163] Rather, they purchased an expectation of profits from the managerial efforts of those controlling the venture. There is no doubt that the investor suffered an economic loss — lost profits and lost consideration for the purchase of the investment. Nor is there any question that the misrepresentation did not cause the entire loss of all profits from the venture or the entire loss of consideration paid for the purchase price of the investment. To the extent that the court's point is that the misrepresenter cannot be liable for the investor's entire losses, including those caused by the casualty, the point is also self-evident.

The only difficult issue indirectly raised by the court's hypothetical is whether the misrepresenter can be liable to the investor for that amount of the purchase price for the investment that would not have been paid absent the misrepresentation. In the remainder of its opinion, however, the court makes clear that the misrepresenter *can* recover that loss. The court concludes that an investor may recover if he can show that the misrepresentation created a "difference between the price paid and the 'real' value of the security, *i.e.*, the fair market value absent the misrepresentations, at the time of the initial purchase by the defrauded buyer."[164] Suppose, therefore, in the court's hypothetical, the investor had paid $100 for a share of stock in the shipping venture; the real or fair market value of the stock would have been only $75 absent the misrepresentation, and the stock after the casualty has become worthless. In one sense, the investor has lost (in addition to profits) the entire $100 paid as consideration for the investment. As the court's hypothetical suggests, a factfinder may well determine that the misrepresentation did not cause that entire loss. But, as the remainder of the court's opinion confirms, there is no doubt that the investor could recover $25 — the difference between the amount of consideration actually paid ($100) and the amount of consideration that would have been paid absent the challenged misrepresentation ($75). No fact-finder could determine that the misrepresentation did not cause *that* loss. Nor will allowing recovery of that precise loss create a scheme of investor insurance.

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163. The hypothetical assumes the application of Rule 10b-5, which in turn presumes the purchase or sale of a security within the meaning of § 3(2) of the 1934 Act, 15 U.S.C. § 78c(2) (1988). If the investment instrument is labeled "stock," it nonetheless will not be a security unless it has attributes commonly associated with stock ownership, such as an expectation of profits. If instead the instrument is not labeled stock, but is still deemed to be a security, it necessarily is an investment in a common enterprise when the investor is led to expect profits from the efforts of others. *See* Reves v. Ernst & Young, 110 S. Ct. 945 (1990).

164. *Huddleston*, 640 F.2d at 556.

IV. Toward the Abandonment of Loss Causation

The preceding section of this Article shows that no support for requiring Rule 10b-5 plaintiffs to prove that the defendant's conduct caused the posttransaction decline in the value of their investments can be found. This section demonstrates that in the absence of any real support, the independent element of "loss causation" has no place in a Rule 10b-5 action. Although one court has suggested that the phrase "loss causation" is "confusing" because it diverts judicial attention from the kind of transactions protected by Rule 10b-5,[165] the phrase is more confusing because it diverts judicial attention from the kind of losses that are recoverable under Rule 10b-5. The concept should be abandoned in favor of a rule of liability and damages that recognizes that the only losses recoverable in a Rule 10b-5 case are those fixed at the time of the securities transaction by the defendant's material misstatement or omission.

The measure of damages in all Rule 10b-5 actions is determined as of the time of the transaction. The Supreme Court and the circuit courts agree that the typical measure of damages in Rule 10b-5 cases is the out-of-pocket rule.[166] The plaintiff under that measure may recover the difference between the price at which the stock was traded and its fair value, measured as of the time of the transaction.[167]

Although the federal courts may be moving in the direction of encouraging a rescissory measure of damages under Rule 10b-5,[168] even this measure attempts to fix damages at the time of the transaction. Numerous devices have been used to arrive at the amount of rescissory damages. The full purchase price will be returned when the defendant has induced the plaintiff to enter the market in the first place; in other words, when the omissions or misstatements are so material that they have induced an investment rather than a price.[169] The difference between the purchase price and the plaintiff's resale price within a reasonable

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165. LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931 (7th Cir.) ("the terms 'loss causation' and 'transaction causation' . . . have been confusing in practice because they do not link the definition of 'causation' to any theory about why people might be liable under the securities laws"), *cert. denied*, 109 S. Ct. 311 (1988).

166. *See supra* note 158 and cases cited therein.

167. Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972).

168. *See* Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611 (1985) (law of damages in security cases's comprised of simple principles leading to intelligible rules of damages based on net harm offender's acts caused others).

169. *See, e.g.*, Nelson v. Serwald, 576 F.2d 1332, 1338-39 (9th Cir.) (proper measure of damages is defendant's profit when defendant made material omissions as to value of stock and defendant's gain from ultimate sale of stock was greater than plaintiff's loss for selling stock to defendant at below fair market value), *cert. denied*, 439 U.S. 970 (1978).

time after discovery of the fraud will be used when the defendant concealed facts so material that a reasonable investor could have deduced from them the resale price.[170] Conversely, when the plaintiff is a seller, the disparity between purchase price and the plaintiff's cost of covering by repurchasing the stock a reasonable time after discovery of the fraud may be used when the misstatements or omissions induced the plaintiff to forfeit the repurchase opportunity.[171]

The resale price measure and the cover measure both limit rescissory recovery to a measure of the materiality of the challenged misstatements or omissions assessed at the time of the transaction.[172] They have been compared to the Uniform Commercial Code's damages provisions that foster beneficial postbreach commercial activity by limiting damages to a measure of the precise wrong, also measured as of the date of the transaction.[173]

The judicial use of equitable limits on rescissionary relief has the same effect. Although privity is no longer a requirement for rescission, promptness or diligence generally is.[174] Requiring the plaintiff to make a prompt election of rescission mitigates the plaintiff's damages to the disparity between the price paid and the fair value of the stock at the time of the transaction. If rescission is prompt, that disparity can be determined at a date close to the transaction date, or better still, at a date that reflects a fully informed market price.

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170. *See, e.g.*, Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1341-46 (9th Cir. 1976) (Sneed, J., concurring) (recovery of out-of-pocket damages possible when sales price of stock before fraud discovered exceeded original purchase price).

171. *See, e.g.*, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 105-06 (10th Cir.) (when investors sold stock as result of deceptively gloomy press release, proper measure of damages is amount investors would have needed to reinvest within reasonable period of being informed by curative press release), *cert. denied*, 404 U.S. 1004 (1971).

172. *See* Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360-61 (8th Cir. 1977) (when investor was fraudulently induced to participate in bond merger account program, rescissory damages measure properly applied), *cert. denied*, 435 U.S. 951 (1978); Chasins v. Smith, Barney & Co., 306 F. Supp. 177, 178-79 (S.D.N.Y. 1969) (difference between purchase price and sale price proper measure of damages when plaintiff did not become aware of material omission until after stock sold at loss), *aff'd*, 438 F.2d 1167 (2nd Cir. 1970).

173. Jordan v. Duff & Phelps, 815 F.2d 429, 440 (7th Cir. 1987) (UCC limits seller's damages to unpaid contract price less market price at time of delivery, providing incentive to sell on market; purchaser's damages limited to market price at time breach discovered less contract price, providing incentive to cover) (citing U.C.C. §§ 2-706, -708, -711, -713), *cert. dismissed*, 485 U.S. 901 (1988).

174. *See id.* at 440 (prompt demand for rescission important in allocating risks among parties because allowing belated election between market damages and rescission effectively lets investor do both and subjects defendant to damages greater than loss actually suffered).

Under the labels of the resale measure, the cover measure, or equitable limits on rescission, courts have fashioned relief that approximates the difference between the price and the value of the security at the time of the transaction. Although courts find generally that the out-of-pocket measure or rescissionary measure of damages are viable alternatives, they have applied those measures only as evidentiary tools to a single end — fixing loss at the moment of the transaction.

Because the only loss recoverable under Rule 10b-5 is the difference between the price and the value of the security at the time of the transaction, any posttransaction decline in value of a plaintiff's investment can never in itself provide the basis for recovery. Instead, posttransaction declines — particularly those that follow the disclosure of the fraud — may at most provide the evidentiary starting point for an analysis of the amount by which the fraud altered the transaction price. Posttransaction declines are evidence of loss, they are not loss itself. Accordingly, whether the defendant's conduct causes a posttransaction decline is irrelevant to the issue of whether the defendant's conduct causes loss. The issue of whether the defendant's conduct has caused loss thus reduces to whether the defendant's misstatement or omission has created a disparity between the transaction price and the value of the security at the time of the transaction.

The terms "transaction causation" and "loss causation" should therefore be abandoned entirely as independent concepts. They should be replaced by the singular requirement that the plaintiff show that the defendant's misstatement or omission created a disparity between the transaction price and the value of the securities at the time of the transaction.

V. Life After Loss Causation

The application of this singular concept clarifies and reconciles the apparent conflicts within courts.[175] For example, the observed split in

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175. *See* Bastian v. Petren Resources Corp., 892 F.2d 680, 685 (7th Cir.) (noting that "such conflict as there is appears to be within rather than among circuits"), *cert. denied*, 110 S. Ct. 2590 (1990). One scholar has observed that courts have distinguished securities cases against brokers or persons in privity with the plaintiff from all others, as those in which the plaintiff may recover damages in the amount of the full posttransaction decline in the value of his investment. Merritt, *supra* note 16, at 510-15. Professor Merritt then argues that the distinction is invalid and that all plaintiffs should be able to recover their "gross losses" when the defendant cannot prove the absence of causation. *Id.*

The distinction on which Merritt premises his critique, however, is a false one. The observed distinction between loss recoverable in privity as opposed to nonprivity cases is based entirely upon Judge Sneed's concurrence in Green v. Occidental Petroleum Corp., 541 F.2d 1335 (9th Cir. 1976). *See* Merritt, *supra* note 16, at 511-13 (citing *Green*, 541

the Second Circuit on the issue of loss causation is reconcilable. In *Marbury Management* itself, the majority and the dissent both find that the defendant's misrepresentation created a difference between the price plaintiffs paid for their securities and the price they would have paid absent the misrepresentations. There, a trainee in a brokerage firm misrepresented his expertise, inducing plaintiffs to overcome their misgivings and purchase securities that later declined in value. In addressing the issue of causation, both the majority and the dissent relied heavily upon the common law for the view that only losses proximately caused

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F.2d 1335 (Sneed, J., concurring). The concurrence is criticized for its apparent distinction between privity cases in which rescissory damages are recoverable and nonprivity, open market cases in which only out-of-pocket damages are recoverable. Merritt, *supra* note 16, at 512-13. But the reason rescissory damages are generally employed in privity and generally not employed in nonprivity cases is not *because* of privity or its absence. Rather, a rescissory method of measuring damages is generally a useful tool in nonopen market cases because the posttransaction value or resale price of the security is the only indicium of the security's value at the time of the transaction. When plaintiff sues, as plaintiff must to recover rescissory damages, a reasonable time after the disclosure of the fraud, the postdisclosure value or resale price of the security is the only evidence of the value of the concealed information. In open market transactions, by contrast, when the market price impounds all available information about the security, the difference between that price and the true value of the securities at the time of the transaction can be measured without reference to the plaintiff's posttransaction conduct because the drop in market price when the fraud is disclosed is strong evidence of the value of the concealed information. Thus, although rescissory concepts may appear in privity cases, those concepts are merely tools used in such cases by courts to determine the price-value disparity created by concealed information at the time of the transaction.

The observed "exception" for broker-dealer fraud is similarly misunderstood. Professor Merritt cites Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980), and Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978), as prime examples of an award of full losses *because* they involved broker-dealers. Yet, those cases employed a rescissory damage measure not because they involved broker-dealers, but because the misrepresentations made by the broker-dealers were so material as to induce the plaintiffs to part with their entire purchase price. In *Marbury Management*, the plaintiff received his entire purchase price discounted by any residual value of his securities because the gross misrepresentation of the broker's expertise altered not just the price at which the plaintiff decided to invest, but the very decision to invest. 629 F.2d at 708. Similarly, in *Garnatz*, the Eighth Circuit allowed the investor to obtain rescissory damages representing his full purchase price not because the defendant was a broker, but because the broker's misrepresentations about the marketability of the bond were so material that they, too, altered the very decision to invest. 559 F.2d at 1361. When, as in *Garnatz* and *Marbury Management*, the "gravamen" of the plaintiff's complaint is not that the plaintiff bought at an unfair price, but that the plaintiff bought at all, a rescissory measure of calculating loss is an accurate approximation of the materiality of the challenged misrepresentations and omissions. Thus, "gross loss" is never a proper measure of "loss" in a securities case — not even in privity or broker-dealer cases. However, gross loss can, in these contexts, serve as important evidence of the recoverable loss that is fixed as of the date of the transaction.

by the misrepresentation could be recovered.[176] Both also agreed that the relevant date for fixing losses is the date of sale.[177]

Where the opinions truly diverge is in their assessments of the materiality of the trainee's misrepresentation that he was a "portfolio management specialist." In affirming the lower court's award of damages as the difference between the transaction price and the posttransaction value of their securities, the majority reasoned that the trainee's misstatements were so material that in their absence plaintiffs, particularly given their trepidations, would not have invested at all.[178] The misrepresentations therefore created a disparity between the plaintiffs' transaction price and the amount they would have paid had they known the truth, which was equivalent to the full transaction price. Judge Meskill, by contrast, did not share the majority's belief that the misrepresentations were so material. He reasoned that the misrepresentations may have altered the initial price at which plaintiffs invested, but they were not so strong as to alter plaintiffs' very decision to invest.[179] Although the judges have different views of the materiality of the misrepresentation — an issue ultimately for the factfinder — they do not have different views of the application of causation to Rule 10b-5 actions.

Judge Meskill's subsequent majority opinion in *Bennett v. United States*[180] is similarly reconcilable. The Bennetts alleged that the defendants loaned them money based on the misrepresentation that the Federal Reserve's margin rules do not apply to a public utility stock deposited with a bank as collateral. In concluding that the Bennetts could not recover for the decline in value of securities purchased with the loans, Judge Meskill reasoned that the misrepresentation was not material; it had no effect on whether and at what price plaintiffs were induced to trade in securities.[181]

Judge Meskill himself reasoned that the result is consistent with *Marbury Management*. He observed that the "essence" of *Marbury Management* is that the "stock in question did not have the value represented by the 'broker.'"[182] The misrepresentation there was so

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176. *See Marbury Management*, 629 F.2d at 708-10; *id.* at 717-23 (Meskill, J., dissenting).

177. Judge Meskill's dissent, of course, rejects the recovery of posttransaction declines in value. *Id.* at 723 (Meskill, J., dissenting). But, even the majority, in affirming the first court's computation of damages, recognizes that stock prices on dates subsequent to the transactions are evidence of the loss fixed on the date of the transactions. *Id.* at 707, 709.

178. *Id.* at 708.

179. *Id.* at 723 (Meskill, J., dissenting).

180. 770 F.2d 308 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986).

181. *Id.* at 314.

182. *Id.*

material that it "both induced the purchase and related to the stock's value."[183] In *Bennett*, by contrast, the misrepresentation was not material — it "neither induced the purchase nor related to the stock's value."[184] Despite the apparent differences in rhetoric, the Second Circuit is consistent: plaintiffs may recover damages when the defendant's misrepresentation or omission creates a difference between the transaction price and the value of the securities at the time of the transaction.

The Eleventh Circuit shares this consistent view. In *Currie v. Cayman Resources Corp.*, that court affirmed the grant of directed verdict against an investor in a limited partnership because the investor could not show a "causal relationship between the alleged untruths and his pecuniary loss."[185] In *Bruschi v. Brown*,[186] that court reversed the summary judgment against an investor, reasoning that the investor had created a factual issue as to whether defendants caused her losses.[187] The cases are identical, however, in their analysis of the requirements of proving "loss causation." The plaintiff in *Currie* failed to prove "loss causation" because he could not show that the consideration he received in exchange for his securities was less than it would have been absent the misrepresentation."[188] The plaintiff in *Bruschi*, on the other hand, avoided summary judgment by creating a factual issue as to whether the defendant "caused her losses by misrepresenting the intrinsic worth of the . . . securities as of the time of the misrepresentations."[189] The results are different, but the reasoning is the same. The concept of loss causation discussed at length in both cases is irrelevant to that reasoning. When the defendant's misstatement or omission alters the transaction price, plaintiffs can recover the amount by which the price was altered.

Even the strong, divergent views of causation developing in the Seventh Circuit have this principle in common. In *LHLC Corp. v. Cluett, Peabody & Co.*,[190] Judge Easterbrook, after criticizing the terms "transaction causation" and "loss causation," collapsed the two concepts into a single appropriate inquiry as to "whether the information disclosed or withheld effected an *investment* decision."[191] According to Judge

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183. *Id.*

184. *Id.*

185. 835 F.2d 780, 785 (11th Cir. 1988).

186. 876 F.2d 1526, 1530-31 (11th Cir. 1989).

187. *Id.* at 1531.

188. *Currie*, 835 F.2d at 785.

189. 876 F.2d at 1531. Although *Bruschi* suggests that even posttransaction declines in value may be recovered when the defendant's representations are "inherently related" to the subsequent losses, the court remands for trial on the issue of loss as of the time of the transaction. *Id.*

190. LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928 (7th Cir. 1988).

191. *Id.* at 931 (emphasis in original).

Easterbrook, information that affects an investment decision is information that alters the price of the transaction, or the decision to invest. Such price-altering information is deemed "material" information by federal securities laws.[192] Accordingly, when the defendant utters a material misrepresentation, the utterance by definition creates a disparity between the transaction price and the value of the securities at the time of the transaction. If, as the court suggests, a misrepresentation or omission is truly material, it will always "cause" recoverable losses. In order to recover under Rule 10b-5, therefore, plaintiffs need only show that the defendant's misrepresentation or omission was material; they need not show that the defendant's conduct caused any posttransaction price movement.

Indeed, in a case subsequent to *LHLC*, Judge Easterbrook declared that posttransaction price movements were so irrelevant to the issues of loss and causation under Rule 10b-5 that a plaintiff could recover damages even when the value of his investment *increased* after the transaction. In *Goldberg v. Household Bank F.S.B.*,[193] the court makes explicit what is implicit in many other loss causation opinions: the "drop" in market price "when the truth appears is a good measure of the value of the information, making it the appropriate measure of damages."[194] Posttransaction price-drops are only relevant as a measure of the value of the information concealed at the time of the transaction. A plaintiff's recoverable loss is equivalent to the value of that concealed information. When a defendant conceals information of value to a securities transaction, therefore, he causes a recoverable loss. Information of value to a securities transaction is material information. Accordingly, a defendant who conceals material information causes recoverable losses under the securities laws.[195]

That the requirement of "loss causation" is indistinguishable from the requirement of materiality is further demonstrated by a close examination of the Seventh Circuit's decisions in *Bastian*[196] and *DiLeo*.[197] In *Bastian*, the district court dismissed plaintiffs' Rule 10b-5 claim.

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192. *Id.* "But materiality usually refers to the importance of the information; a datum that would have only a small effect on the price is not material, while a datum with the potential for a larger effect is." *Id.*

193. 890 F.2d 965 (7th Cir. 1989).

194. *Id.* at 966-67.

195. Because loss is a function of the materiality of the concealed information at the time of the transaction, the court declared, "a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss." *Id.* at 966.

196. Bastian v. Petren Resources Corp., 892 F.2d 680 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

197. DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990).

Although their complaint alleged that "but for" the defendant's misrepresentations concerning their integrity and competence, plaintiffs would not have invested in a failed oil and gas limited partnership, plaintiffs failed to allege that the defendant's misrepresentations actually caused their investments to lose their value.[198] The case raises the issue of whether plaintiffs must allege and ultimately prove in a securities fraud action that the defendant's conduct was the cause of the decline in the value of their securities. Judge Posner, writing for the Seventh Circuit, seems to opine that plaintiffs must not only allege, but must also sustain the burden of proving that the defendant's fraud caused the decline in the value of their investments.

In reaching that apparent result, Judge Posner analogizes securities fraud to the law of torts. Loss causation, he opines, is nothing more than "an instance of the common law's universal requirement that the tort plaintiff prove causation."[199] He further writes: "'Loss causation' is an exotic name perhaps an unhappy one, . . . for the standard rule of tort law that the plaintiff must allege and prove that, but for the defendant's wrongdoing, the plaintiff would not have incurred the harm of which he complains."[200] As in medical malpractice cases in which the plaintiff must prove that the patient would have lived longer absent the wrong, so too in securities fraud cases, the plaintiffs should have to prove that the investment would have fared better absent the wrong.[201] According to Judge Posner, it is not enough for the plaintiffs to prove that the defendants caused them to part with their money; rather, they must prove that the defendants caused their investments to fail.[202]

In applying this requirement to the allegations in the cases, Judge Posner demonstrated that the issue of (loss) causation is indistinguishable from that of the materiality of the misrepresentations, as of the time of the transaction. The court assumed that the plaintiffs wanted to invest their money in an oil and gas limited partnership, the competence and honesty of the general partners had only limited materiality. In other words, had the plaintiffs known of the defendant's incompetence, they still would have invested in some oil and gas limited partnership — either the same one at a lower price or a different one at the same price. According to Judge Posner's reasoning, if the plaintiffs could have shown that the nondisclosures in the case created a disparity between the price a reasonable investor would have paid for an oil and gas

198. *Bastian*, 892 F.2d at 684-85.
199. *Id.* at 684.
200. *Id.* at 685.
201. *Id.* at 684.
202. *Id.*

partnership and the price they actually paid, they would have recovered the amount of that disparity.

Judge Posner's counter-example further proves the point. When a broker gives false assurances to a customer that an investment is "risk-free" and a risk materializes, the customer, according to Judge Posner, may readily establish that the broker caused his losses. In such a case, the customer, if he had known the truth, would presumably not have parted with his money in an equally risky investment. Accordingly, the broker has caused the customer's losses. But in both the broker hypothetical and the oil and gas situation, the defendant's fraud has not actually caused the investment to decline in value. Even the broker cannot be said to be the *actual* cause of the decline in value of the risky stock.

Rather, the two cases are distinguishable based on the different levels of materiality of the two misrepresentations. The nondisclosure of the questionable competence of the general partners in an oil and gas venture is simply less material than the misrepresentation that an investment is risk-free. The broker's misrepresentation is so material, in fact, that the plaintiff may be able to show that he would not have entered into the investment at all had he known the truth, in which case the measure of his recovery would be the entire purchase price. Hence, Judge Posner's own example demonstrates that (loss) causation can be established by showing that the omissions were material — they created a quantifiable disparity between trading price and true value.

In *DiLeo v. Ernst & Young*,[203] however, the Seventh Circuit, through Judge Easterbrook, suggested yet another version of the loss causation requirement. There, plaintiffs alleged that the accounting firm of Ernst & Young was liable under Rule 10b-5 for certifying financial statements that failed to disclose that Continental Bank had not sufficiently increased its reserves to protect itself from troubled loans. The court stated that plaintiffs cannot prevail unless they show that the decline in the price of the stock they purchased "is attributable to fraud,"[204] and not simply to failed business performance.

Yet, Judge Easterbrook suggested that it may not be enough even for plaintiffs to prove that the defendant's conduct caused their losses. Instead, he suggested that liability for securities fraud should follow only if the defendant's conduct makes *all* investors worse off:

> When a firm loses money in its business operations, investors feel the loss keenly. Shifting these losses from one group of investors to another does not diminish their amplitude, any more

203. 901 F.2d 624 (7th Cir. 1990).
204. *Id.* at 627.

> than rearranging the deck chairs on the Titanic prevents its sinking. Revealing the bad loans earlier might have helped the DiLeos, but it would have injured the other investors by an equal amount. The net is a wash.[205]

Judge Easterbrook here indicated that omissions which do not harm investors as a whole, on a net basis, cannot be the predicate for securities fraud. Such omissions have not caused investor losses or investor injury.

This concept has been previously explored by Judge Easterbrook. First, in a law review article, Judge Easterbrook analogized to the principle of "antitrust injury"[206] and reasoned that damages in securities law cases should not be awarded unless the defendant's conduct causes a net loss to all investors.[207] Second, Judge Easterbrook in *Flamm v. Eberstadt*[208] earlier opined that: "Rule 10b-5 is about *fraud* after all, and it is not fraudulent to conduct business in a way that makes investors better off — that all investors prefer ex ante and that most prefer even ex post."[209] The difficulty with Judge Easterbrook's insistence upon this concept of "securities injury" or "investor net harm" is that the Supreme Court expressly rejected that approach as backwards reasoning from a policy of economic efficiency.[210]

Whether backwards or not, Judge Easterbrook's theory in application merely requires a court to quantify the materiality of a challenged omission. If the DiLeo's had alleged that the failure to disclose the unsatisfactory reserves created a disparity between the price at which they purchased Continental securities and the true value of the securities at the time of the transaction, they could have proved that investors as a whole had suffered because the market for those securities as a whole would have been defrauded. Loss causation or net harm, therefore, are "exotic" names for the difference between transaction price and value created by the defendant's conduct.[211]

VI. Conclusion

Loss causation became a virtually insurmountable evidentiary barrier to plaintiffs only after transaction causation became an easily surmountable evidentiary barrier. The fact that one concept magically re-

205. *Id.*
206. Easterbrook & Fischel, *supra* note 168, at 647-48.
207. *Id.* at 651.
208. 814 F.2d 1169 (7th Cir.), *cert.denied*, 484 U.S. 853 (1987).
209. *Id.* at 1177.
210. *See* Basic Inc. v. Levinson, 485 U.S. 224, 235 (1988).
211. Rankow v. First Chicago Corp., 870 F.2d 356, 367 (7th Cir. 1989) (citing Kademian v. Ladish, 792 F.2d 614, 628 n.11 (7th Cir. 1986)).

placed the other in prominence suggests that their labels may be unimportant to the judges who employ them. What may be more important to the judiciary is finding some mechanism to insure that before plaintiffs exact from defendants a monetary award, they must show a significant connection between the defendant's unlawful conduct and their losses.

There can be no doubt, however, that anyone who makes a misrepresentation or omission that increases the price at which a reasonable person purchases a security, or decreases the price at which a reasonable person sells a security, causes some loss. Under traditional damages principles, that out-of-pocket loss is plainly recoverable. Yet, if the loss causation confusion continues to grow, plaintiffs will be unable to recover such losses unless they can prove that the misrepresentation or omission also caused a posttransaction decline in the value of their investment.

The source of the loss causation confusion is obvious. It stems from a failure to define the losses that are recoverable under the federal securities laws. The failure is needless. Recoverable loss under those laws is easy to define: it is the difference between the transaction price and the value of a security, measured at the time of the transaction. Although posttransaction declines may provide evidence of these transaction-based losses, posttransaction declines are not in themselves recoverable loss. Indeed, the federal securities laws were not designed to prevent declines in the value of an investment any more than they were designed to encourage increases in the value of an investment. Rather, the fundamental objective of those laws is to insure that investors have full and accurate information from which to decide whether the transaction price of a security reflects its fair value. That fundamental decision, which is what the federal securities laws protect, is of course, made at the time of the transaction.

Because the doctrine of loss causation as it has evolved does not recognize the time of the transaction as the point of potential loss in a securities transaction, it ultimately disserves the very purpose of the securities laws. Only by abandoning the confusing concept of loss causation can courts redress the loss that those laws were truly designed to prevent — the loss to investor autonomy.

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ESSAY

Who's Been Sleeping in My Bed? You and Me, and the State Makes Three

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I. INTRODUCTION

Recently a married woman narrowly escaped a trial,[1] the possibility of two years in prison, and a $10,000 fine for a crime that an estimated sixty percent of the adult American population has committed.[2] Donna E. Carroll, a Wisconsin woman, was charged with having an adulterous affair.

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The author wishes to thank Professors John Sanchez and Bob Jarvis for their helpful comments and criticisms.

1. The 26-year-old Wisconsin woman was spared a trial when she agreed to perform 40 hours of community service and undergo two months of parental counseling. Chicago Tribune, May 8, 1990, at 2, col. 3. Her attorney made it clear that the woman agreed to these sanctions not as an admission of guilt, but only to avoid trial. The Times (London), May 9, 1990, Overseas News.

This widely reported case "prompted disbelief and hilarity in the liberal northern cities but won approval from many conservative and religious groups." *Id.*

2. "Despite all the hush-hush, the morality, and the vendettas against those involved in them, affairs are extremely common. Almost everyone engages in one in his or her life at some time." L. LINGUIST, SECRET LOVERS xi (1989). Dr. Linguist estimates 70% of married men and 50% of married women have affairs. She also calculates that approximately 60% of all single people have had a sexual relationship with a married person. *Id.* Shere Hite and Alfred Kinsey also conclude as many as 70% of spouses have been be unfaithful. Ft. Lauderdale Sun Sentinel, Sept. 6, 1990, at 9E, col. 1.

Another author estimates that 50% of all married men and women have affairs. M. SANDS, THE MAKING OF AN AMERICAN MISTRESS 190 (1981).

The aborted prosecution in this widely publicized case highlights both the ineffective and overly moralistic tenor of present adultery laws and the troublesome possibility of the ease with which this legislation may be abused through selective enforcement. Paradoxically, however, this bizarre case — reminiscent of a very different, more sexually repressive era — could actually spark positive results if judges and legislators respond by reevaluating adultery[3] laws. This Essay proposes repeal of adultery legislation because continued criminalization improperly interjects the State into one of the most private decisions a person makes — choosing a sexual partner.

Unfortunately, in this age of negative political campaigning, when charges of being "liberal" are hurled about as if it were some unspeakable, heinous crime, many legislators are simply too frightened to seek repeal of these statutes. Judges compound the problem by refusing to strike adultery statutes. These jurists seem remarkably undaunted by questionable tactics employed to shore up predetermined conclusions of validity. Judicial maneuvers include manipulated interpretations of precedential Supreme Court cases and rejection of a common sense analysis of the constitutionally based right of privacy.[4]

This Essay uses the Wisconsin case as a backdrop to illustrate unavoidable obstacles in prosecutions for sexual behavior between consenting adults. It contends that the constitutional right of privacy, properly interpreted, sweeps broadly enough to protect adults from such government intervention. It explores problems seemingly inherent in existing adultery statutes, including the bald truths that these laws simply do not achieve their ostensible goals and that they are widely ignored by a majority of Americans. In this extremely sensitive arena of sexual activity between consenting adults, criminal laws are both inappropriate and ineffective attempts to shape public morals. Accordingly, this Essay concludes that adultery statutes are ripe for repeal.

II. The State Interests

Criminalization of adultery[5] is presumably justified by two state

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3. Adultery means sexual intercourse between consenting adults during a time when at least one of the partners is married to someone else. Adultery is distinguished from fornication, which is sexual intercourse between unmarried, consenting adults.

4. *See infra* text accompanying notes 19-43.

5. Many states have abolished criminal fornication laws. This Essay advocates the abolition of adultery laws as well, even though public policy could support different treatment of the two crimes. Indeed, that some states have eliminated criminal penalties for fornication but retained criminal penalties for adultery reflects legislative recognition of this distinction. The Supreme Court's conclusion that prohibition of adultery is constitutional, without reference to fornication laws, further supports this distinction. *See infra* text accompanying notes 19-48. Because the two statutory prohibitions impose criminal liability for private sexual activity between consenting adults, both should be repealed.

interests: 1) protecting innocent spouses[6] from potential harm, and 2) protecting public morals.

First, although the State has a legitimate interest in protecting spouses, an extramarital relationship arguably does not pose a sufficient threat to that interest to overcome the fundamental right of privacy granted by the Constitution.[7] Second, purported undermining of public morality fails to support criminalization because of the absence of persuasive evidence of resulting harm.[8] Furthermore, if the issue really is morality, and if the test is refraining from extramarital sex, the battle is long lost. The striking numbers of Americans who are having, or have had, affairs illustrate the futility of continuing this war. Indeed, the stubborn legislative prohibition of this ubiquitous behavior, in the face of continued refusal to prosecute violators, is a shaky foundation on which to build morality. Recently, many public people have forcibly learned this bitter lesson. The public generally refuses to forgive those who blatantly lie about private peccadillos such as sexual liaisons.[9] On

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6. Children may also be adversely affected by a parent's adultery, but this Essay is limited to the rights of, and obligations to, a marital partner.

7. *See infra* text accompanying notes 19-43.

8. *Cf.* Eisenstadt v. Baird, 405 U.S. 438, 453 (1971) (quoting Baird v. Eisenstadt, 429 F.2d 1398, 1402 (1st Cir. 1970)) (arguing that without "demonstrated harm" the State lacks the power to declare contraceptives immoral). *Eisenstadt* was not an adultery case. Instead, the issue was the right of single people to buy contraceptives in light of the Supreme Court decision recognizing this right for married persons. *Eisenstadt* is useful, however, as evidence that in privacy cases the Court is willing to require actual proof of harm as a condition to a determination that certain conduct is immoral.

9. Probably the best example is the meteoric rise and fall of politician Gary Hart. A former Colorado senator, Hart announced his candidacy for President by calling for all Americans to "try to hold ourselves to the very highest standards of integrity and ethics, and soundness of judgment . . . ." The Miami Herald, May 10, 1987, at 1A, col. 8. Immediately following this announcement, Hart became the acknowledged Democratic front runner. But he was forced to withdraw from the race when the media widely reported he was having an extramarital affair. Hart and his alleged girlfriend adamantly denied an intimate relationship, even as contrary evidence mounted. Hart's brief re-entry into the race, during which he claimed a right to privacy in his personal relationships, was met with resounding indifference.

Voters, initially impressed with Hart's call for integrity and ethics, abandoned him when his hypocrisy was exposed. In fact, many people speculate that it was not the extramarital affair which doomed Hart, but rather his arrogance and hypocrisy in taunting the press to follow him as he consistently denied rumors that he had had an affair.

Allegations of drug abuse provide an analogous situation. For example, outrage among conservatives forced Douglas Ginsburg to withdraw his name from consideration as a Supreme Court Justice nominee following disclosure of his previously secret, past marijuana use. The Miami Herald, Nov. 8, 1987, at 1A, col. 1. However, despite similarities, the initial disclosures about Gary Hart and Douglas Ginsburg produced very different responses from other public people. The Ginsburg disclosure led to an almost religious

the other hand, most of the public continues to respect famous people who confess similar embarrassing incidents, responding honestly[10] to inquiries rather than dissembling.

The message is clear: Americans are fed up with hypocrisy. The time has come to repeal adultery statutes because, even assuming such laws served legitimate goals when adopted, they fail to reflect current reality. To appreciate this argument, it is necessary to understand that early adultery statutes were designed to ensure a wife's fidelity. Fidelity was essential to protect the husband's "property" interest in his wife and to guarantee any child for whom he would be financially responsible was his biological child.[11] Various aspects of modern society and technology have toppled these historical underpinnings: the notion of the wife as a chattel has been rejected; birth control methods have vastly improved; and paternity tests are virtually foolproof. As society and technology evolve, states should jettison outdated laws.

Moreover, if the goal of adultery laws is deterrence, civil causes of action that have been abolished in most jurisdictions,[12] in contrast to the criminal laws, are more likely to achieve the desired result.[13] These abolished tort claims provided the potential additional benefit of financially compensating the "injured" spouse.[14] Nevertheless, these civil ac-

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zeal to "confess" past drug use. Even Tipper Gore, a self-proclaimed conservative crusader for morality, volunteered that she had tried marijuana. Senator Gore's own admission that he had experimented with marijuana did not appear to adversely affect his presidential aspirations. In contrast, no one rushed forward to admit extramarital relations after the Hart debacle. This distinction may support an argument that admitted but past drug use is more acceptable to the public than are extramarital affairs.

10. Barney Frank, a liberal congressman from Massachusetts, provides an interesting example. Concern that constituents would reject him because of his homosexuality forced him to remain "in the closet" for years. However, his fears proved unfounded as Frank's revelation of his sexual preference failed to diminish his popularity. Real threat to his re-election occurred only after information surfaced of a male prostitution ring operated by one of Frank's lovers from Frank's home. Although Frank terminated the operation as soon as he learned of it, he initially attempted to hide the incident, and serious questions about his future political career were raised. In other words, voters supported Frank's right to privacy and to a personal homosexual lifestyle, which arguably falls outside the mainstream. They only threatened to abandon him upon discovery that he attempted to cover up a potentially embarrassing scandal.

As a result of the attempted coverup, the House ultimately voted to reprimand Frank for bringing discredit to Congress. The majority rejected Republican efforts to impose more severe sanctions. The Washington Post, July 27, 1990, at A1.

11. Oppenheim v. Kridel, 236 N.Y. 156, 160, 140 N.E. 227, 229 (1923).

12. Case Note, 26 J. Fam. L. 459, 461 (1987-88).

13. *But see* Comment, *Stealing Love in Tennessee: The Thief Goes Free*, 56 Tenn. L. Rev. 629 (1989) (arguing that the potential for abuse outweighs any positive effects).

14. *See* Note, *The Case for Retention of Causes of Action for Intentional Interference with the Marital Relationship*, 48 Notre Dame L. Rev. 426, 429 (1972). The

tions were properly repealed. Even the limited involvement of merely providing a judicial forum to decide such extremely private disputes is inappropriate.[15]

III. The Wisconsin Case

It is really a fairly common situation — a wife's alleged infidelity causes her husband to seek divorce and custody of their child. But then the case took an extraordinary turn. The husband filed a criminal complaint against his wife based on adultery she admitted during a family court hearing. The district attorney claimed he had no choice but to prosecute because adultery is still against the law and "strong evidence" of a violation was presented. Failing to prosecute would be tantamount to "declar[ing] the statute null and void."[16]

The wife raised several defenses. She denied committing adultery. She also reasoned that abolition of adultery as grounds for divorce precluded punishment under the criminal law. Her argument that criminal prosecution is contrary to the goal of preserving marriage was more convincing. Criminal adultery trials, or even the mere threat of prosecution, erode rather than enhance the probability for survival of the marriage. Many spouses decide to overlook or forgive infidelity, choosing to preserve their marriage following termination of an affair.[17] However, reconciliation seems virtually inconceivable after a criminal adultery pros-

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author argues that "any deterrent function is strictly ancillary to the major purpose of providing a means by which an injured party may be recompensed." *Id.*

15. *Cf.* L. Pamela P. v. Frank S., 59 N.Y.2d 1, 449 N.E.2d 713, 462 N.Y.S.2d 819 (1983). The court argued that the State should not interfere in cases of contraceptive fraud between two private individuals. Rather, the State may intervene only when the issue concerns government restriction on an individual's right to procreate. "This aspect of the right of privacy has never been extended so far as to regulate the conduct of private actors as between themselves. Indeed . . . *judicial inquiry into so fundamentally private and intimate conduct as is required to determine the validity of the respondent's assertions may itself involve impermissible State interference with the privacy of these individuals.*" *Id.* at 6-7, 449 N.E.2d at 716, 462 N.Y.S.2d at 821-22 (emphasis added).

16. New York Times (National), Apr. 30, 1990, at A1, col. 5. Attempts to dismiss this case as aberrant must fail because similar prosecutions are being reported in other states. In fact, four people recently were charged with adultery in Connecticut. Sachs, *Handing Out Scarlet Letters; Antiquated Sex Laws Turn Into a Bludgeon for Divorcing Spouses*, Time, Oct. 1, 1990, at 98. "In a quirky twist to the contemporary no-fault-divorce saga, venerable adultery laws occasionally are being invoked by quarreling marital partners, sometimes for vindictive purposes and sometimes to gain leverage in lengthy settlement negotiations." *Id.*

17. In fact, thousands, if not millions, of words have been written advising spouses on what to do when faced with a partner's infidelity. Many experts suggest attempts to reconcile, at least "as long as the good outweighs the bad." *See, e.g.*, J.P. Schneider, Back From Betrayal 171-201 (1988).

ecution is initiated by a spouse — regardless of whether the filing of charges was motivated by a desire for revenge or merely an understandably bruised ego and hurt feelings.

Finally, Donna Carroll raised the best and most persuasive objection to adultery statutes,[18] the argument firmly grounded in the constitutionally based fundamental right to privacy. Simply stated, the government cannot legitimately claim a right to criminalize private sexual relations between consenting adults.

IV. The Right of Privacy

In a long line of cases beginning with *Griswold v. Connecticut*,[19] the United States Supreme Court has recognized an individual's right to intimate associations without interference from the State. Indeed, a harbinger of this right of privacy may be traced as far back as 1928 when Justice Brandeis argued for "the right to be let alone."[20] The contents of this right remain amorphous despite its long and established history. Indeed, even Supreme Court Justices disagree on whether the right extends to protect all private sexual activity between consenting adults.

A recent case restricting the right of privacy vividly illustrates this fundamental split among the Justices. In *Bowers v. Hardwick*,[21] a sharply divided Court[22] inexplicably rejected the notion that "any kind of private sexual conduct between consenting adults is constitutionally insulated from state proscription."[23] This archane analysis exposes *Bowers* as an ill-advised retreat from the Court's movement toward full recognition of individuals' privacy rights.

In *Bowers*, the challenged Georgia law contained no restrictions concerning the status of persons covered, but rather prohibited certain sexual conduct. The Court carefully limited its decision to the specific facts, holding only that homosexuals have no fundamental right to engage in sodomy.[24] Nevertheless, slicing through the majority's rhetoric, this limitation suggests the Court actually decided State approval of sexual conduct can legitimately depend on choice of partner. This conclusion

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18. The Wisconsin American Civil Liberties Union is expected to push for repeal of the state adultery statute in the next legislative session relying on this argument of a couple's fundamental right to privacy. Chicago Tribune, May 8, 1990, at 2, col. 3.

19. 381 U.S. 479 (1965).

20. Olmstead v. United States, 277 U.S. 438, 478 (1928) (Brandeis, J., dissenting).

21. 478 U.S. 186 (1986).

22. Two concurring and two dissenting opinions were filed in addition to the opinion of the Court.

23. 478 U.S. at 191.

24. *Id.* at 192.

is inescapable in light of the Georgia Attorney General's concession that the statute would be unconstitutional if applied to a married couple.[25] In other words, disingenuously masquerading as a decision addressing constitutionally unprotected sexual activity, *Bowers* actually endorses prohibition of sexual acts only when the State objects to an individual's choice of partner. In an argument similar to the one used to support adultery statutes, the *Bowers* Court decided that consensual sodomy[26] is not constitutionally protected because it is outside a marriage and within a homosexual relationship.[27]

This conclusion is problematic. The Court in *Eisenstadt v. Baird*[28] established that a statute regulating intimate relationships which is unconstitutional when applied to a married couple is also unconstitutional when applied to a single person. "If the right of privacy means anything, it is the right of the *individual*, married or single, to be free from unwarranted governmental intrusion into matters so fundamentally affecting a person as the decision whether to bear or beget a child."[29] Moreover, arguments that the Justices intended to limit this right of privacy to contraceptive cases are easily countered by *Eisenstadt*'s reliance on first[30] and fourth[31] amendment cases as precedent. These references support the notion that the Supreme Court in *Eisenstadt* was protecting

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25. *Id.* at 218 n.10 (Stevens, J., dissenting). The Court was able to avoid the issue because the married plaintiffs were denied standing by the lower courts. They "had neither sustained nor were in immediate danger of sustaining any direct injury from the enforcement of the statute." *Id.* at 188 n.2.

26. The Georgia statute includes a broad definition of the crime: "(a) A person commits the offense of sodomy when he performs or submits to any sexual act involving the sex organs of one person and the mouth or anus of another . . . ." *Bowers*, 478 U.S. at 188, n.1 (quoting GA. CODE ANN. § 16-6-2 (1984)).

27. A recent Georgia Supreme Court case arguably casts some doubt on this conclusion. The defendant in Ray v. State was convicted and sentenced to ten years in prison for paying a 14-year-old boy to engage in sodomy. 389 S.E.2d 326, 328 (Ga. 1990). The court rejected defendant's argument of selective enforcement against homosexuals, finding insufficient evidence in the record to support his claim. *Id.* at 327-28. The logical inference is that the statute constitutionally could be applied against heterosexuals; otherwise, the discussion concerning the lack of evidence of selective enforcement would be superfluous. Nevertheless, upholding defendant's conviction in *Ray* was appropriate for two other reasons. First, rather than a consenting adult, defendant chose a 14-year-old boy as his sexual partner. Special protection for children, presumably legally incapable of informed consent, is appropriate. *See infra* text accompanying notes 33-34. Second, defendant was actually guilty of prostitution because he paid the child to engage in sodomy. The right of privacy does not apply to prostitution. *Ray*, 389 S.E.2d at 328.

28. 405 U.S. 438 (1972).

29. *Id.* at 453 (emphasis in original).

30. *Id.* at 453 n.10 (citing Stanley v. Georgia, 394 U.S. 557 (1969)).

31. *Id.* at 453-54 n.10 (citing Olmstead v. United States, 277 U.S. 438 (1928)).

an individual's basic "right to be let alone — the most comprehensive of rights and the right most valued by civilized man."[32]

The conclusion that consenting adults have a constitutionally protected right of privacy to choose sexual partners without State intervention inexorably follows from this analysis. Nevertheless, in a brief opinion, most notable for its paucity of persuasive legal reasoning, the Supreme Court in *Bowers* stubbornly refused to strike the statute, at least as applied.

Bowers is troubling for another, related reason. Despite the Court's clear attempt to severely limit its applicability, the case is disturbing because of its implicit assumption that the federally mandated right of privacy does not deny states the power to legislate their own ideas of morality — even to prohibit behavior as fundamental as choice of sexual partner.

Distressing, too, is that the *Bowers* Court fell into a trap, frequently set by proponents of restrictive sexual legislation. Scrambling to buttress the argument that the State can and should regulate private sexual behavior, advocates analogize adultery to incest, which they apparently believe is running amok in bedrooms throughout the country. This highly inflammatory comparison to incest is irrelevant and little more than a dishonest attempt to influence policy by provoking and exploiting strong negative emotions actually unrelated to the issue of adultery. Unfortunately, although the analogy is groundless, it is raised so frequently it cannot be ignored. In fact, the contrast helps highlight and define the appropriate point for State intervention.

Incest and adultery are often linked because both involve sexual behavior usually performed in private. Nevertheless, analysis exposes the absence of similarity beyond this superficial commonality; it also lays the foundation for separate legal treatment of the two. Actually, the differences are far more fundamental and persuasive than any imagined parallels. The principal distinction is that incest typically involves sexual conduct with a child, a person presumed legally incapable of consent. In addition, incestuous sexual contact often occurs through the exploitation of power that results from a family relationship. In other words, the dominant family member abuses his or her power position to "persuade" the dependent child to "consent" to sex. Generally ignored or misunderstood is another important difference: unlike adultery, sexual gratification is rarely the true motivation for incest, but rather satisfaction of other subconscious emotional needs of the abusive adult. The most critical distinction, however, is that incest is never a victimless crime. Even worse, the victim is vulnerable and rarely in a position to help

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32. *Id.*

himself or herself. Further, and not surprisingly, research shows sexual abuse almost inevitably harms the child.[33]

Under these circumstances, an absolute ban on incestuous behavior easily satisfies strict scrutiny analysis mandated by the fundamental right to privacy. The State's compelling interest in protecting innocent children from abuse is indisputable. On balance, this interest is sufficient to justify infringement on any right to incest an adult may claim. In addition, because of the nature of incest, including its strong, almost universally negative consequences, total prohibition of this conduct is narrowly tailored to effectuate the State's interest, also required under strict scrutiny analysis.[34]

Indeed, protection of children is an interest that often justifies special restrictions of fundamental rights. For example, the Court recently decided the first amendment does not prohibit a State from criminalizing possession of child pornography in a person's home. *Osborne v. Ohio*[35] explicitly distinguished an earlier and arguably precedential case based on substantial differences in the balance of the implicated interests. In the earlier case, *Stanley v. Georgia*,[36] the Court struck down a statute prohibiting private possession of obscene material. The Supreme Court in *Stanley* found the asserted State interest "to control public dissemination of ideas inimical to the public morality"[37] inadequate to justify impinging upon an individual's fundamental first amendment right to receive information privately. Although the Court in *Osborne* assumed a similar first amendment interest in viewing and possessing child pornography, it contrasted the cases based on the underlying State interests. The State's interest in *Stanley* was not substantial, but

> a State's interest in "safeguarding the physical and psychological well-being of a minor" is "compelling". . . . The legislative judgment, as well as the judgment found in relevant literature, is that the use of children as subjects of pornographic materials

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33. *See generally* Coleman, *Incest: A Proper Definition Reveals the Need for a Different Legal Response*, 49 Mo. L. Rev. 251 (1984). *See also* Coleman, *Sex in Power Dependency Relations: Taking Unfair Advantage of the Fair Sex*, 53 Alb. L. Rev. 95, 100-03 (1988) (discussing incest as an abuse of trust arising from the family relationship).

34. "When a statutory classification significantly interferes with the exercise of a fundamental right, it cannot be upheld unless it is supported by sufficiently important state interests and is closely tailored to effectuate only those interests." Zablocki v. Redhail, 434 U.S. 374, 388 (1978).

35. 110 S. Ct. 1691, 1696 (1990).

36. 394 U.S. 557 (1969).

37. *Osborne*, 110 S. Ct. at 1696 (quoting Stanley v. Georgia, 394 U.S. 557, 566 (1928)).

> is harmful to the physiological, emotional, and mental health of the child.[38]

The Court buttressed its holding with the observation that it is "surely reasonable"[39] to conclude child pornography will decrease if possession is criminalized.[40]

It is merely a short and obvious step to analogize the differences in *Stanley* and *Osborne* to distinctions between adultery and incest. Adultery statutes prohibit conduct between consenting adults primarily because that behavior is viewed as "inimical to the public morality."[41] Incest, on the other hand, remains taboo to protect "the physical and psychological well-being of a minor."[42] Furthermore, mindful of the stark reality that many Americans have extramarital affairs, it is "surely [not] reasonable"[43] to pretend that criminalizing adultery has or will inhibit the behavior. Accordingly, it is entirely consistent to seek repeal of adultery statutes and, at the same time, endorse vigorous enforcement of incest laws.

V. Failure to Achieve Ostensible Goals

Criminal laws serve the important functions of either deterring or punishing harmful misconduct. Adultery statutes should be repealed because they fail to achieve either goal. Moreover, the prohibited behavior simply is not verifiably harmful to the State.

The assumption that adultery is harmful is problematic. Criminal regulation of private, consensual sexual conduct is arguably indefensible absent compelling evidence of harm either to the marriage relationship or other spouse.[44] In other words, when no injury to the marriage or spouse exists, the State presumably has no compelling interest to justify intervention. Absent a compelling state interest, attempts to regulate consensual sexual behavior impermissibly infringe on an individual's constitutional rights. Moreover, even assuming a State interest in protecting innocent spouses from harm which adultery might cause, that interest is neither sufficient to justify the intrusion necessary to discover

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38. *Id.* (quoting New York v. Ferber, 458 U.S. 747, 756-58 (1982)).

39. *Id.*

40. *Id.* Justice Brennan, in dissent, disagreed. He argued the majority was wrong to focus on *Ferber* rather than *Stanley*. "*Ferber* held only that child pornography is 'a category of material the *production* and *distribution* of which is not entitled to First Amendment protection' . . . our decision did not extend to private *possession*." *Id.* at 1712 (emphasis in original) (quoting *Ferber*, 458 U.S. 747, 765 (1982)).

41. *Stanley*, 394 U.S. at 566.

42. *Osborne*, 110 S. Ct. at 1696.

43. *Id.*

44. *See infra* text accompanying notes 57-63.

infidelity, nor to trample fundamental rights of consenting adults. The final argument for repeal is a pragmatic one: although adultery may sometimes cause harm,[45] criminal prohibitions are doomed to fail in deterrence or punishment.

A. Failure to Deter

Adultery statutes do not deter the prohibited conduct for several reasons. Although the vast majority of people are capable of exercising control over their sexual behavior, the sex drive itself seems virtually irrepressible. Consequently, it is naive to expect that merely criminalizing sexual behavior will suppress this strongest of all biological drives.[46] Indeed, when an estimated sixty percent of American adults have extramarital affairs, it is hardly credible to suggest criminal laws have had any deterrent effect. In fact, the danger associated with forbidden conduct may enhance the sexual experience, paradoxically increasing the likelihood it will occur.

However, the obviously unrealistic nature of the goal of deterrence is not the sole reason that such legislation should be abolished. Another compelling justification for repeal of adultery statutes is the practice of police, prosecutors, and judges who conspire, at least implicitly, to reject these laws by refusing to enforce them. Ironically, judges actually point to non-enforcement to excuse their failure to strike these statutes. Rather than objecting to the abuse inherent in selective prosecution,[47] judges cavalierly dismiss the problem because the "history of nonenforcement suggests the moribund character today of laws criminalizing this type of private, consensual conduct."[48]

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45. *Id.*

46. It is interesting to note that fundamental to enforcement of fornication laws is the even more absurd expectation that a normal unmarried adult — whether hetero- or homosexual — will be celibate. This also means, of course, that a person who never marries is apparently expected to live a lifetime without sex.

47. *Cf.* Potter v. Murray City, 585 F. Supp. 1126 (D. Utah 1984), in which the court acknowledged without apparent distress that despite the fact that "between 5,000 and 10,000 individual family members of polygamist families" live in the state, no more than 25 had been prosecuted since 1952. *Id.* at 1129. This case is particularly interesting because Utah, like the State of Georgia in *Hardwick*, refused to prosecute for violation of the relevant criminal law. *Id.* at 1133.

Although *Potter* was not an adultery prosecution, the analogy is potentially illuminating. In *Potter*, as might be expected in an adultery prosecution, the court used the long-established tradition of monogamy to uphold state and federal constitutions and laws prohibiting polygamy. *Id.* at 1137. The court affirmed Potter's dismissal from the police department because his polygamous marriage was a violation of his oath to uphold these laws. *Id.* at 1143.

48. Bowers v. Hardwick, 478 U.S. 186, 198 n.2 (1986) (Powell, J., concurring).

This reasoning is specious for at least two reasons. First, if the statutes are so "moribund," why not just eliminate them? Second, both *Bowers v. Hardwick*[49] and the Wisconsin adultery case undermine any comfort individuals might find in historical failure to prosecute. Although the government refused to prosecute Hardwick "unless further evidence developed,"[50] the continued existence of the Damoclean sword obviously is intended to chill sexual behavior. So long as Georgia criminalizes sodomy, Hardwick and others are faced with the following undesirable options: Break the law and risk prosecution no matter how remote the probability, practice celibacy, or limit sexual gratification.[51] The apparently nonexistent deterrent effect of adultery legislation makes it likely that the vast majority will choose to ignore the law. Such wholesale disregard may result in a disturbing decrease in respect for laws in general. Furthermore, although the Wisconsin case was settled short of a trial, Mrs. Carroll was charged, treated like a criminal, so embarrassed by press coverage she was forced to move to another town, and ultimately compelled to agree to sanctions of community service and parental counseling.[52] It is unlikely Justice Powell could convince either Michael Hardwick or Donna Carroll of "the moribund character" of sodomy and adultery laws.

At the same time, the State's consistent failure to prosecute saps any hope of effective deterrence. Absent fear of enforcement, laws are simply ignored.[53] Although exact data on the prevalence of extramarital affairs is not available because most people are understandably reluctant to admit adultery, little doubt exists that these laws are frequently

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Although Justice Powell was referring to "prosecution for private homosexual sodomy" rather than adultery, the underlying rationale is the same. *Id.* The last adultery prosecution in New York was in 1944. New York Times, *supra* note 16, at A9. This is particularly interesting because adultery was the only grounds for divorce in New York until September 1, 1967. N.Y. Dom. Rel. Law § 170:1 (McKinney 1988) (Practice Commentaries). The point is that divorces were granted based on adultery, but no criminal charges were filed.

49. 478 U.S. 186 (1986).

50. *Id.* at 188. It is unclear to what possible "further" evidence the Court could be referring. The arresting officer walked into the bedroom while Hardwick and a male friend were performing mutual oral sex, an obvious violation of the statute. In fact, the only reason for upholding the statute and discussing "further evidence" apparently would be to chill future sexual behavior by Hardwick and others.

51. Gratification is adversely affected if a homosexual is denied the right to a same-sex sexual partner or any couple is precluded from engaging in non-harmful, consensual sexual activity.

52. *See supra* note 1 and accompanying text.

53. A simple example from everyday life illustrates this point. A majority of drivers ignore the 55 mile per hour speed limit on interstate highways unless they spot a police officer.

violated.[54] In fact, if estimates are to be believed, the unfaithful actually outnumber those who have never strayed!

Perhaps sheer numbers partially explain legal reluctance to prosecute adultery. The impossibility of arresting and possibly even imprisoning all these "criminals" certainly contributes to the failure to enforce. Additionally, the statutes might not be enforced as a tacit recognition that adultery is often not harmful and sometimes even beneficial.[55] Unhappily, many legislators refuse to acknowledge this view.

The primary legal issue implicated by adultery statutes is the constitutionally based right of privacy.[56] This argument, however, necessarily rejects the Supreme Court's consistent assertions — so far raised only in dicta — that adultery lies outside the penumbras and emanations of privacy.[57] The State's asserted interest for regulating adultery seems to be an arguably misguided solicitude for the innocent spouse. Underlying this concern is an apparently irrebuttable presumption that adultery destroys, or at least harms, a marriage. Despite superficial appeal, this assumption is frequently incorrect. First, there is the obvious, but often conveniently ignored, threshold question about the stability and marital "bliss" existing in a relationship in which one partner chooses to wander. This logic actually motivated repeal of complementary tort actions. "Human experience is that the affections of persons who are devoted and faithful are not susceptible to larceny - no matter how cunning or stealthful."[58] Unfortunately, this argument poses the proverbial chicken or egg question, leading to the same inconclusive and nonproductive results. A second important reason to question the irrebutable presumption of harm is that most affairs end within a relatively short time, after which the straying spouse generally returns home.[59] Third, para-

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54. Furthermore, although the exact number of sexually active single people is also unknown, it is certainly high. Sex between unmarried consenting adults arguably causes no significant harm to society, and, unlike in adultery, no innocent third persons are involved who may be hurt. Consequently, the State has no compelling interest to protect. Therefore, laws restricting such behavior unconstitutionally infringe on an individual's right of privacy.

55. *See supra* notes 47-48 and accompanying text.

56. Adultery statutes also arguably abridge the constitutionally protected freedom of association. U.S. Const. amend. I.

57. *See, e.g.*, Griswold v. Connecticut, 381 U.S. 478, 499 (1965) (Goldberg, J., concurring) (quoting Poe v. Ullman, 367 U.S. 497, 553 (Harlan, J., dissenting)). Grouped together in this exclusion is homosexuality. *Id.*

58. Funderman v. Michelson, 304 N.W.2d 790, 791 (Iowa 1981).

59. When a spouse discovers his or her partner is having an affair, some experts advise doing nothing if the spouse wants the marriage to continue. "Most affairs last three months, and 90 percent of cheating spouses return home." Brothers, *Why Wives Have Affairs*, Parade Magazine, The Miami Herald, Feb. 18, 1990, at 4-5.

Most affairs are short term. Only approximately 16% last longer than a year. M. Sands, *supra* note 2, at 190.

doxically perhaps, many spouses report that having an affair actually strengthened their marriages.[60]

A related argument focuses on the possible "great values in love affairs, that the joys of such a relationship can be unique and unmatched in their intensity, and that for those involved in them they can sometimes be more meaningful even than the fulfillments of monogamous marriage."[61]

Furthermore, the assumption that adultery destroys marriage contains a subtle, but fundamental, fallacy. Inextricably interwoven into the very fabric of this argument is the fervently held, but possibly unjustified, belief that monogamy has inherent value and is thus essential for any successful marriage. In spite of the superficial seductiveness of this idea, reasons to doubt it do exist.

Consider that a majority of married people have affairs. A logical inference might be that monogamy is simply not natural.[62] In some cultures monogamy is not the norm. It may be that these cultures accept multiple sexual partners as a reflection and fulfillment of societal needs different from those that embrace monogamy. Nevertheless, it seems equally possible that the implicit message is that human beings are not naturally monogamous. Assuming the validity of this conclusion, and recognizing that American society imposes monogamy as an element of the marital relationship, spouses may face an unpleasant choice between two intolerable options. First, they can restrict themselves to one sexual partner, acting contrary to nature but consistent with society's artificial constraints. This resolution may cause dissatisfaction with life in general and marriage specifically. Partners become bored and, remaining reluctant to violate marriage vows, seek relief in divorce.

The second scenario, an alternative to divorce, is also undesirable. Faced with a fundamentally non-monogamous nature, many spouses do stray. However, because of societal disapproval, they must lie to spouses and others about their affairs. Although perverse, they may even resent their spouses and marriage for "forcing" them into this uncomfortable predicament. Furthermore, of course, faithful spouses may be injured if they discover their partners' dishonesty.

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60. One couple wrote a book about their experiences in coping with the husband's infidelity after 11 years of marriage. They contend working through the emotions caused by infidelity helped them build a stronger, more satisfying and honest marriage. At the time their book was published, the couple had been married 25 years and had two children. They are psychologists who work as a husband-wife consulting team. *See generally* J. & P. Vaughan, Beyond Affairs (1980).

See also L. Linguist, *supra* note 2, at 18. "[M]any affairs can be quite beneficial to the individual, his or her marriage, and to those around him or her." *Id.*

61. R. Taylor, Having Love Affairs 185 (1982).

62. L. Linguist, *supra* note 2, at 197.

Trust and agreement on the essential aspects of the relationship are the foundation of a successful marriage. If parties marry promising monogamy, breach of that promise damages the relationship. But the harm results not from any sexual dalliance; rather, it results from violation of trust and breach of the agreement.[63] Consequently, if a couple chooses sexual freedom,[64] rather than monogamy, as the basis of their relationship, arguably an affair would not adversely affect the marriage. Instead, the relationship would be harmed by either party objecting to an affair because the objection itself would breach their agreement.[65]

Admittedly the current definition of marriage conflicts with this argument. Despite the Supreme Court's consistent reference to marriage as a fundamental right,[66] states regulate who can marry and prescribe terms of the relationship. Consequently, states mandate that marriage requires sexual exclusivity. This results in the incongruous situation that adults may negotiate terms of any other contract but apparently are precluded from defining the parameters of their most important and intimate relationships.[67]

Another reason to abolish adultery laws exists: many laws are simply too vague to withstand constitutional challenge. For example, a Florida statute prohibits "liv[ing] in an open state of adultery."[68] The statute includes neither definitions nor explanations. Is a single sexual encounter with a married person sufficient to violate the statute, or is open and notorious cohabitation required? Such uncertainty is inconsistent with

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63. J.P. SCHNEIDER, *supra* note 17, at 193-94. "One of the biggest costs of affairs is the loss of trust. . . ." *Id.* at 193.

64. Today a realistic fear in any non-exclusive sexual relationship is the possibility of contracting, and spreading to the "innocent" partner, sexually transmitted diseases. Consistent with the argument advanced throughout this Essay, the appropriate resolution of this problem is discussion, and agreement, between the partners. This legitimate fear does not, however, validate State intervention in private, intimate relationships.

65. F. PITTMAN, M.D., PRIVATE LIES, INFIDELITY, AND THE BETRAYAL OF INTIMACY 19-29 (1989). The author contrasts infidelity with adultery. He defines adultery "as a sexual act outside of marriage" and infidelity as "sexual dishonesty within the marriage." *Id.* at 22. Throughout this thought-provoking book, he argues injury to the marriage relationship is a consequence of such infidelity.

66. *See, e.g.*, Griswold v. Connecticut, 381 U.S. 479, 485 (1965).

67. The justification for this seeming paradox is that, although in some ways marriage is more a civil contract, unlike other contracts, the state becomes a party to the marriage. The State thus has an interest, generally thought to flow from its interest in protecting children, to regulate marriage and its dissolution. For an interesting discussion of possible changes, see generally Hafen, *The Constitutional Status of Marriage, Kinship, and Sexual Privacy - Balancing the Individual and Social Interests*, 81 MICH. L. REV. 463 (1983).

68. FLA. STAT. § 798.01 (1989).

the ordinary prescription that criminal laws must be well-defined and strictly interpreted.[69]

B. Failure to Punish

Failure to enforce adultery statutes diminishes their deterrent effect and presents a serious obstacle to the second goal of criminal laws — punishment. Obviously, lawbreakers who are neither arrested nor prosecuted cannot be punished.

Furthermore, government punishment of adultery is arguably violative of the constitutional requirement of separation of church and state.[70] Religion, rather than civil law, is the source of adultery laws. Indeed, adultery is a moral,[71] not a legal, issue. Consequently, churches and synagogues should establish prohibitions and punishments for adultery instead of state criminal laws.

C. Other Problems

Related problems associated with modifying sexual behavior through criminal law further decrease the likelihood of enforcement. Because the State is not the injured party, it has no direct interest in actively pursuing convictions. Moreover, even if a State interest in protecting an innocent spouse from potential emotional distress exists, the reality of limited resources dictates other prosecutions take precedence. Regardless of the morality of the choice, violent crimes pose a much more serious and urgent risk to society than adultery. Thus, limited law enforcement resources are allocated, and frequently depleted, in fighting more life-threatening criminal activity.

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69. Furthermore, laws affecting sexual behavior are problematic even when prohibitions and punishment are explicitly described. For example, although the state sodomy statute seems clear, it is unlikely that many Georgia residents are aware that they could be sentenced to 20 years in jail for a single act of oral sex. *See supra* note 26.

Of course, interpretations of apparently unambiguous language may cause confusion. *Bowers* is, once again, illustrative. The Georgia sodomy statute criminalizes certain behavior without regard to the offenders' sex or marital status. *Id.* Nevertheless, the *Bowers* Court refused to decide the constitutionality of this statutory prohibition as applied to sodomy between heterosexuals. *Bowers*, 478 U.S. at 188 n.2.

70. U.S. Const. amend. I.

71. *Bowers* concluded that supporting the majority's views of morality is a legitimate basis for sodomy legislation. 478 U.S. at 196. Laying aside the question as to the correctness of such a ruling in a country with a political system designed and dedicated to protect minority views, the cases are distinguishable because the Supreme Court in *Bowers* rejected the notion that the Georgia statute implicated a fundamental right. Absent a fundamental right, the law need only satisfy the rational basis test. Without discussion, the Court simply asserted the law meets the test because it is "constantly based on notions of morality." *Id.*

Assuming adultery does cause harm sufficient to warrant some legal remedy, the person injured is the partner of the adulterous spouse. The innocent spouse suffers the emotional trauma generally associated with infidelity. Consequently, he or she is the interested and appropriate party to seek redress through the legal system.

Common law obliged by allowing the innocent spouse to sue in tort.[72] Criminal conversation, the civil counterpart of adultery,[73] approached a strict liability tort. It required little more than proof of sexual intercourse with plaintiff's spouse. The only recognized defenses to criminal conversation were denial of the affair or proof that plaintiff consented.[74] Nevertheless, although an "innocent" spouse may be injured by the sexual involvement of his or her marital partner, tort recovery has been virtually eliminated for a variety of reasons.[75]

VI. Conclusion

Properly interpreted, the established fundamental right to privacy requires repeal of adultery statutes. Attempted criminal regulation of private consensual sexual conduct is impermissible absent proof of harm to the State. Tort actions should also be abolished. Bedrooms are simply not large enough to accommodate sexual partners and the spectre of legislators, police, lawyers, and judges.

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72. The original source of these actions was a master's quasi-proprietary interest in his servant. At common law, a wife was considered her husband's valuable servant, providing him with a protectible right to consortium. Because a wife had no separate identity, she had no protectible interest in his services and, therefore, initially was denied the right to sue. However, as women's rights grew, courts recognized a wife's concomitant marital rights. Note, *The Suit of Alienation of Affections: Can Its Existence Be Justified Today?*, 56 N.D.L. Rev. 239, 242 (1980).

73. *See, e.g.*, Fadgen v. Lenkner, 469 Pa. 272, 277, 365 A.2d 147, 149 (1976). Another common law action created to protect the marital relationship was alienation of affections. This tort required proof that defendant's wrongful conduct caused actual loss of affections toward plaintiff. Sexual intercourse was not an essential element of the claim. Although damages were originally awarded for loss of services, the real basis of recovery was loss of consortium. Note, *supra* note 72, at 243-44.

74. *Fadgen*, 469 Pa. at 277, 365 A.2d at 149.

75. One of the most compelling arguments for abolishing alienation suits is that "spousal love is not property which is subject to theft." Fundermann v. Mickelson, 304 N.W.2d 790, 794 (Iowa 1981).

Other reasons to abolish alienation suits include: 1) the opportunities for blackmail because defendant's reputation may be ruined simply by filing suit; 2) the absence of any reasonably definite standards for assessing damages; 3) the availability of punitive damages makes excessive verdicts likely; and 4) the seemingly forced sale of spouse's affections based upon psychological assumptions contrary to fact. H. Clark, Jr., The Law of Domestic Relations in the United States, § 10.2, at 267 (1968). It is interesting that this section has been eliminated in the recent edition of this text, which focuses instead

The innocent spouse injured by adultery has not been abandoned by the legal system. The appropriate remedy is divorce, where the State grants the means to "put asunder" those whom it has previously joined together.

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on loss of consortium actions in the parent-child relationship. H. Clark, Jr., The Law of Domestic Relations in the United States, § 11.2, at 388-90 (2d ed. 1988). Professor Clark includes a section on actions for loss of spouse's consortium based on negligent interference with the marital relationship *Id.* § 11.3, at 390-98.

An action for alienation of affections "diminishes human dignity. It inflicts pain and humiliation upon the innocent, monetary damages are either inadequate or punitive, and the action does not prevent human misconduct itself." Wyman v. Wallace, 549 P.2d 71, 74 (Wash. Ct. App. 1976), *rev'd*, 91 Wash. 2d 317, 588 P.2d 1133 (1979), *vacated*, 94 Wash. 2d 99, 615 P.2d 452 (1980). Furthermore, many critics believe both actions should be abolished because they conflict with the change in status achieved by women in the last century. Note, Hunt v. Hunt: *The Status of "Heartbalm" Torts in South Dakota*, 27 S.D.L. Rev. 160, 163-64 (1982).

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NOTES

Redefining the New Value Exception to the Absolute Priority Rule in Light of the Creditors' Bargain Model

I. Introduction

In Chapter 11[1] bankruptcy reorganizations, the debtor's equityholders frequently seek to retain ownership of the firm. When the reorganization plan fails to provide for full payment of all the creditors' claims, one issue often arises — under what circumstances should the equityholders be permitted to retain an ownership interest in the reorganized firm? The answer to this question depends upon the weight given to the rules that attempt to accommodate Chapter 11's two potentially antagonistic objectives: the protection of creditors' rights and the promotion of successful reorganizations.[2]

The absolute priority rule protects creditors' "bargained for rights." It demands that creditors receive full payment of their claims in their established order of priority before lesser interests, such as those of equityholders, may share in the assets of the reorganized firm.[3] Section A of Part II of this Note will examine both the historical development and the current state of the absolute priority rule.

Commentators and the judiciary suggest that the new value exception to the absolute priority rule operates to promote successful reorganizations, but at the expense of creditors' rights.[4] Originally established in 1939, the new value exception provides that equityholders who infuse new capital into the firm may retain an interest in the reorganized firm if

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1. Bankruptcy Code of 1978, 11 U.S.C.A. §§ 101-1330 (West 1979 & Supp. 1989) [hereinafter Bankruptcy Code].

2. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After* Ahlers, 63 Am. Bankr. L.J. 221, 223 (1989).

3. Powlen & Wuhrman, *The New Value Exception to the Absolute Priority Rule: Is* Ahlers *the Beginning of the End?*, 93 Com. L.J. 303, 303 (1988).

4. *See, e.g., In re* Potter Material Service, Inc., 781 F.2d 99 (7th Cir. 1986); Levin, *Retention of Ownership Interest Over Creditor Objection - How Intangible and Unsubstantial May the Substantial Contribution Be?*, 92 Com. L.J. 101 (1987).

certain conditions are satisfied.[5] If these conditions are met, the bankruptcy court may confirm the reorganization plan over the objections of creditors, notwithstanding the plan's non-compliance with the absolute priority rule.[6] Section B of Part II will discuss the development of the new value exception.

Two significant events have occurred since 1939 that arguably signal the abrogation of the new value exception. First, the enactment of the Bankruptcy Code of 1978 significantly altered the Bankruptcy Act of 1898.[7] Second, the United States Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*,[8] involving the Court's first foray into this area since 1978, failed to confirm the viability of the new value exception.[9] Part III analyzes these two events' effect upon the present vitality of the new value exception.

Part IV provides a conceptual model to aid in this Note's attempt to diffuse the tension between the absolute priority rule and the new value exception. It focuses upon Dean Thomas Jackson's "creditors' bargain" model of bankruptcy.[10] The creditors' bargain model seeks to vindicate the creditors' bargained-for rights of priority in the bankruptcy process.[11]

Section A of Part V offers a critique of the new value exception in light of the creditors' bargain model, and concludes that the two are irreconcilable. In an attempt to preserve the new value exception's ability to promote successful reorganizations under certain circumstances, Section B of Part V proposes a restructuring of the new value exception to better accommodate the creditors' bargain model.

II. Conflicting Roles: The Absolute Priority Rule and the New Value Exception

A. *The Absolute Priority Rule*

The absolute priority rule requires that a dissenting class of creditors be provided for fully before any junior class may receive or retain any interest in the reorganized firm.[12] The rule originated at the end of the

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5. *See* Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939).
6. *Id.*
7. Bankruptcy Code, *supra* note 1.
8. 485 U.S. 197 (1988).
9. *Id.* at 203-04 n.3.
10. *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlement and the Creditors' Bargain*, 91 Yale L.J. 857 (1982).
11. *Id.*
12. *See In re* Future Energy Corp., 83 Bankr. 470, 497 (Bankr. S.D. Ohio 1988).

nineteenth century under the law of equity receiverships when many of the railroads' capital structures were reorganized.[13] In equity receivership reorganizations, senior creditors frequently found the value of their interests reduced, while the equityholders, who were often a part of the railroad's management, usually retained an interest in the railroad.[14] This result occurred not as a function of the existing law, but rather as a result of the reorganization negotiations between the senior creditors and the equityholders.[15] The general creditors were often "frozen out," or given only a small amount for their interests.[16] In order to combat possible collusion by the senior creditors and equityholders, courts developed the absolute priority rule.[17] Thus, the rule prevented senior creditors and equityholders from recombining their interests and finding themselves with ownership interests in the same firm free of the claims of the general creditors.[18]

Drawing upon these experiences, Congress codified the absolute priority rule.[19] Section 77B of the Bankruptcy Act of 1898 required that, as a prerequisite to confirmation, a reorganization plan be "fair and equitable."[20] Fair and equitable was a term of art that had acquired fixed meanings through judicial interpretations in the area of equity receivership reorganizations.[21] One definition of "fair and equitable" was that a junior interest could not receive any property or interest in the reorganized company unless the senior claims or interests were paid in full.[22] Accordingly, the courts considered the absolute priority rule "firmly imbedded in Section 77B."[23]

Under section 77B, the absolute priority requirement was mandatory and could not be waived by the creditors' consent.[24] Similarly, Chapter

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13. *See* Baird & Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. Chi. L. Rev. 738, 739 (1988).

14. *Id.* at 739-40.

15. *Id.*

16. *Id.*

17. *Id. See, e.g.*, Northern Pac. R.R. v. Boyd, 228 U.S. 482 (1913).

18. *See* Baird & Jackson, *supra* note 13, at 739-40.

19. *See* Case v. Los Angeles Lumber Co., 308 U.S. 106 (1939). *See generally* Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 Colum. L. Rev. 125 (1928); Foster, *Conflicting Ideals for Reorganization*, 45 Yale L.J. 923 (1935); Gerdes, *General Principles of Plans for Corporate Reorganization*, 89 U. Pa. L. Rev. 39 (1940).

20. Section 77B(f) stated that "[a]fter hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible . . ." *Case*, 308 U.S. at 114 n.6.

21. *Case*, 308 U.S. at 115.

22. *Id.* at 115-16.

23. *Id.* at 119.

24. In *Case*, the Court explained, "It is clear from a reading of Section 77B(f)

X of the Bankruptcy Act, which succeeded section 77B in 1939, required full compliance with the absolute priority rule.[25]

In 1978, Congress passed the Bankruptcy Code, which superceded the 1898 Bankruptcy Act. Although much precedent was expressly applicable to the new code, controversy developed concerning the applicability of old precedent in several areas. Section 1129(b)(2)[26] is an example. It states in part:

> (2) For purposes of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (B) With respect to a class of unsecured claims-
>
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.[27]

Unlike Section 77B of the Bankruptcy Act, Section 1129(b)(2) provides statutory definitions of "fair and equitable." The second definition, section 1129(b)(2)(B)(ii), is a modification of the earlier version of the absolute priority rule.[28] Rather than applying mandatorily to all reorganization plans as required under the Bankruptcy Act, the absolute priority rule now applies only when a dissenting impaired class of creditors receives less than the full amount of its claims under the proposed reorganization plan.[29] This situation arises under section 1129(b)(1) when, in order to further the purpose of reorganizing the firm, the bankruptcy court may confirm a reorganization plan over the objections of an

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that the Congress has required both the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable'. The former is not a substitute for the latter." *Id.* at 114.

25. *See* Marine Harbor Properties Inc. v. Manufacturers Trust Co., 317 U.S. 78, 85, *reh'g denied*, 317 U.S. 710 (1942).

26. 11 U.S.C.A. §§ 1129(b)(2)(i)-(ii) (West 1979 & Supp. 1989).

27. *Id.*

28. *See In re* Marston Enter. Inc., 13 Bankr. 514, 517 (Bankr. E.D.N.Y. 1981).

29. 11 U.S.C.A. § 1129 (West 1979 & Supp. 1989). *See In re Marston Enter. Inc.*, 13 Bankr. at 517. A class of creditors dissents when less than two-third in amount or one-half in number of the holders of claims in the class vote for the reorganization plan. 11 U.S.C.A. § 1126(c) (West 1979). A class of creditors is "impaired" when its members receive less than full payment of their claims under the reorganization plan.

impaired class of creditors.[30] Section 1129(b)(1) is referred to as the "cram-down" provision of section 1129.[31]

B. The New Value Exception

The United States Supreme Court carved out an exception to the absolute priority rule in 1939. In *Case v. Los Angeles Lumber Products Co.*,[32] the debtor's equityholders sought to retain an ownership interest in the reorganized firm despite the reorganization plan's failure to provide for full payment of each claim.[33] The equityholders attempted to justify this result, arguing that their "financial standing and influence in the community," familiarity with the operation of the business, and the "continuity of management" they could provide the reorganized firm were essential to the success of the reorganization plan.[34]

Writing for a unanimous Court, Justice Douglas explained that equityholders could justify their continued participation in the ownership of a reorganized firm by contributing new resources to the firm.[35] However, to prevent the dilution of creditors' rights resulting from the equityholders' inadequate contributions, the Court mandated that several conditions be satisfied before the Court would confirm a plan that violated the absolute priority rule.[36] The Court required that the contribution be (1) necessary to the success of the reorganization plan; (2) "fresh"; and (3) "reasonably equivalent" in value to the value of the equityholders' continued participation in the reorganized firm.[37] In addition, the equityholders' par-

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30. 11 U.S.C. § 1129(b)(1) (West 1979). The "cram-down" provision reflects a congressional policy of achieving reorganization values over the objections of recalcitrant creditors whose property rights are satisfactorily addressed in the "adequate protection scheme" of § 1129. *In re* Greystone III Joint Venture, 102 Bankr. 560, 563-64 n.3 (Bankr. W.D. Tex. 1989).

31. *See, e.g., In re* U.S. Truck Co., Inc., 800 F.2d 581, 583 (6th Cir. 1986); *In re* Future Energy Corp., 83 Bankr. 470, 490 (Bankr. S.D. Ohio 1988). In addition to complying with either § 1129(b)(2)(B)(i) or (ii), a reorganization plan must also satisfy the "best interests of creditors test." Located in § 1129(b)(1), the test requires each class receive or retain under the plan on account of its claims at least equal the amount that would be received or retained if the debtor were liquidated under Chapter 7 rather than reorganized.

32. 308 U.S. 106 (1939).

33. *Id.* at 111.

34. *Id.* at 122.

35. *Id.* at 121. The Court explained, " 'Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them.' " *Id.* at 117 (quoting Kansas City Terminal Ry. v. Central Union Trust, 271 U.S. 445, 455 (1926)).

36. *Id.* at 122.

37. *Id.* at 121.

ticipation was required to be based on a contribution "in money or in money's worth."[38]

Despite creating an exception to the absolute priority rule, the Court in *Case* rejected the debtor's reorganization plan.[39] The equityholders' consideration fell "far short" of satisfying the requirements of the new value exception.[40] In addition, the Court explained that the equityholders' offering of expertise, influence, and reputation could not "possibly be translated into money's worth reasonably equivalent to the participation accorded to the old stockholders. They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities."[41]

III. The Current Viability of the New Value Exception Under the Bankruptcy Code of 1978

A. *The Uncertainty Begins*

The new value exception was originally developed under the Bankruptcy Act of 1898. Until recently, the courts have preserved the existence of the exception under the Bankruptcy Code of 1978.[42] However, in 1988 the Supreme Court cast doubt upon the existence of the new value exception.

In *In re Ahlers*,[43] the Ahlerses, operators of a family farm, attempted to have a reorganization plan confirmed that allowed them to retain an equity interest in their farm over the objection of an impaired class of creditors.[44] An Eighth Circuit panel did not reject the reorganization plan and found that the Ahlerses' future contributions of labor, experience, and expertise were contributions "measurable in money or money's worth."[45] On the basis of this determination, the court remanded the matter to the district court with directions to determine whether the value of the Ahlerses' yearly contributions of labor, experience, and expertise

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38. *Id.* at 122.

39. *Id.*

40. *Id.*

41. *Id.* at 122-23.

42. *See, e.g., In re* Marston Enter, Inc., 13 Bankr. 514, 518 (Bankr. E.D.N.Y. 1981) ("There is no statutory prohibition against original shareholders making a substantial necessary capital contribution in consideration for which they received shares of stock in the reorganized corporation.").

43. 794 F.2d 388 (8th Cir. 1986), *rev'd*, Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

44. *Id.* at 392-93.

45. *Id.* at 402.

over the life of the plan would equal or exceed the value of the retained ownership interest at maturity.[46]

The Supreme Court reversed the decision of the circuit court.[47] The Court viewed the promises of future services as "intangible, inalienable, and, in all likelihood, unenforceable [promises which could not] be exchanged in any market for something of value to the creditors *today*."[48]

The Court noted in a footnote that the Solicitor General, as *amicus curiae*, urged the Court to hold that the codification of the absolute priority rule in section 1129 eliminated any "exception" to that rule.[49] The Court responded:

> We need not reach this question to resolve the instant dispute. . . . [W]e think it clear that even if the *Los Angeles Lumber* exception to the absolute priority rule has survived enactment of the Bankruptcy Code, this exception does not encompass respondents' promise to contribute their "labor, experience, and expertise" to the reorganized enterprise.[50]

Although the Court circumvented the issue raised by the Solicitor General, the Solicitor General's arguments merit consideration. The first prong of the arguments focused on statutory interpretation and legislative intent. The Solicitor General first noted that unlike Chapter X of the old Bankruptcy Act which provided that a plan had to be "fair and equitable," but did not define the term, the Bankruptcy Code of 1978 supplies two statutory definitions of the term in section 1129(b)(2)(B)(i) and (ii).[51] Accordingly, the Solicitor General argued that by stating the two definitions, the Bankruptcy Code excluded all other definitions.[52]

The Solicitor General contended that even allowing equityholders to make new capital contributions as part of a reorganization plan violates the terms of section 1129(b)(2)(B) unless section 1129(b)(2)(B)(i) is satisfied.[53] Otherwise, the "interest that they receive or retain under the plan is received or retained on account of their pre-petition claim or interest" in the property of the debtor.[54] In other words, the exclusive right of prior equityholders to purchase equity results in a "preemptive

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46. *Id.* at 403.
47. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988).
48. *Id.* at 203 n.3 (emphasis in original).
49. *Id.*
50. *Id.*
51. Brief for the United States as *Amicus Curiae* Supporting Petitioners at 20-21, Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988) (No. 86-958) [hereinafter Brief].
52. *Id.*
53. *Id.*
54. *Id.*

retention" of equity purchase rights by the equityholders, which the absolute priority rule forbids.[55]

The Solicitor General also noted that the Bankruptcy Code permits a creditor class, by a class vote, to assent to a plan that is not "fair and equitable" as defined in section 1129(b)(2) over the objections of minority members, provided two-thirds of the total dollar amount of the claims within that class and one-half of the actual number of creditors within that class vote to affirm the plan.[56] The Solicitor General argued that this provision of the Code, which restricts the ability of creditors to block confirmation of a reorganization plan, coupled with the codification of two definitions of "fair and equitable," "leave[s] no room to allow an equityholder to buy his way into the reorganized company over the objections of an impaired class of creditors."[57]

The Solicitor General also argued that the legislative history of section 1129(b) is devoid of congressional intent to maintain the new value exception. In support of this contention, the Solicitor General quoted a House Report that described the then proposed section 1129(b): "The general principle of the subsection permits confirmation notwithstanding non-acceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan."[58] Furthermore, according to the Solicitor General, even if the legislative history was silent on the new value exception's vitality, the language of section 1129(b) would be a sufficient indication that the exception no longer existed because "[i]t would be extraordinary to require the legislative history to *confirm* the plain meaning of [section 1129(b)(2)(B)]."[59]

The second prong of the Solicitor General's argument focused on the policy reasons supporting the new value exception's abrogation due to the enactment of the Bankrupty Code. The Solicitor General argued that unlike in 1939, when the Court believed that the old equityholders might be the only source of new capital to fund the reorganization plan, today's capital markets make this an unrealistic concern.[60] Their structures make it easier for "worthwhile ventures" to obtain financing.[61] According to the Solicitor General, the inability of a reorganizing firm to convince

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55. *See In re* Snyder, 99 Bankr. 885, 888 n.18 (Bankr. C.D. Ill. 1989); Powlen & Wuhrman, *supra* note 3, at 317.

56. Brief, *supra* note 51, at 10 n.6, 20 (citing 11 U.S.C.A. § 1126(c) (1979)).

57. *Id.* at 20.

58. *Id.* at 21 (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 413 (1977)).

59. *Id.* at 21-22 n.20 (quoting Bourjaily v. United States, 483 U.S. 171, 178 (1987) (emphasis in original)).

60. *Id.* at 22.

61. *Id.*

anyone other than the old equityholders to contribute capital suggests that the reorganization is unlikely to succeed rather than that the capital markets have failed.[62]

Implicit in the Solicitor General's argument is the assumption that only "worthwhile ventures" are able to raise capital and all other ventures are unable to do so; that is, that the capital markets are perfectly capable of weeding out ventures with little chance of success. This contention, especially in the bankruptcy arena, is based on erroneous conceptions of the capital markets' role in financing failing ventures.

For example, for the capital markets to function as envisioned by the Solicitor General, all the players in the capital market must possess equal amounts of relevant information concerning the firm to assess whether the firm has the potential to supply the desired return to investors or the ability to make future payments on any debt. In the close corporation and sole proprietorship context, this contention is inaccurate. The former equityholders/managers will undoubtedly possess greater knowledge about the firm and its prospects for success in the future. What may appear a probable failure to those not privy to the inner workings of the firm could actually be a viable opportunity. Furthermore, this informational asymmetry provides the equityholders/managers with a bargaining chip in reorganization negotiations because it enhances both the need for and the value of their skills. They will not relinquish this bargaining chip for the sole purpose of increasing the efficiency of the capital markets.

In addition to the informational asymmetries that prevent the operation of a "perfect" capital market, the broad statement that the failure to raise capital denotes a wasteful enterprise fails to consider the firm-specific skills and knowledge of the former equityholders/managers. The failure to raise capital could be construed as a "statement" by the players of the capital market that they are unwilling to provide capital because they lack or do not have access to the necessary skills or knowledge required to provide the enterprise with its greatest chance for success. On the other hand, if the former equityholders do possess these attributes, they will offer to supply new capital if they are sufficiently compensated.

In conclusion, speculating about why the former equityholders are the only offerors of new capital to fund a reorganization is unreasonable. Linking the new value exception to the functioning of the capital markets is not the solution.

B. The Search for an Answer

In *Ahlers*, the Supreme Court left the new value exception issue unresolved, thus notifying debtors and creditors alike that the current

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62. *Id.*

vitality of the new value exception to the absolute priority rule may be subject to dispute.[63] The Supreme Court's unwillingness to resolve the issue has led to a number of irreconcilable decisions by the bankruptcy and federal courts.

For example, one court has carried the possible interpretations of *Ahlers* to an incorrect extreme. In *In re Rudy Debruycker Ranch, Inc.*,[64] the court stated:

> [T]he Debtor's [sic] further argue that they have made substantial cash contributions to their reorganization plan in the form of inheritance from Mr. Debruycker's father of $50,000.00. Further, they state they will operate the farm without a salary, taking only funds necessary for support. . . . The total unsecured claims equal about $1,257,000.00. The cash contributions, while allowing the [debtors] to retain their equity, pales into the "de minimis" category, even if one were to accept that the exceptions [sic] of *Case* is allowable under the absolute priority rule. In other words, the capital contribution must certainly result in a 100% pay out of unsecured creditors, which is not proposed under the Plan. Finally, the easy answer is that inferred by the *Ahlers* case, namely, there are no exceptions to the absolute priority rule as codified by the 1978 Code. Thus, the only way the rule is satisfied is by payment in full of the senior class.[65]

The above interpretation of *Ahlers* is erroneous because the Supreme Court in *Ahlers* stated that its "decision today should not be taken as any comment on the continuing vitality of the *Los Angeles Lumber* exception . . . ."[66]

Many courts simply have avoided acknowledging that the new value exception rests upon a fragile foundation and instead have conducted business as usual.[67] Other courts have approached the issue with a two-

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63. Powlen & Wuhrman, *supra* note 3, at 314.

64. 84 Bankr. 187 (Bankr. D. Mont. 1988).

65. *Id.* at 189-90.

66. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 203-04 n.3 (1988).

67. *See, e.g.*, *In re* Green, 98 Bankr. 981 (Bankr. 9th Cir. 1989) (mere promise of future services is alone insufficient to satisfy the recognized exception to the absolute priority rule); *In re* Johnson, 101 Bankr. 307, 309-10 (Bankr. M.D. Fla. 1989) (The court explained that "even prior to the enactment of the Bankruptcy Code, the courts recognized an exception to the 'absolute priority rule'. . . . [The new value] exception has been recognized by several courts and is supported by a strong policy consideration which as stated was to permit the infusion of new capital in a reorganized entity in order to assure that the entity is kept alive."); *In re* 47th and Belleview Partners, 95 Bankr. 117 (Bankr. W.D. Mo. 1988).

step analysis.[68] The first step consisted of the courts' recognizing the uncertainty surrounding the new value exception before determining that the exception was still available.[69] In the second step, the courts determined if the exception applied in the cases at hand.[70]

The court in *In re Snyder*[71] summarized two opposing arguments addressing the existence of the new value exception. The court first focused upon section 1129(b) and how the codification of the absolute priority rule may have abrogated the new value exception. The court quoted heavily from the *amicus curiae* brief filed by the United States in *Ahlers*.[72]

In support of the continued viability of the exception, the court noted the "technical argument" that although equityholders cannot retain or receive any property "on account" of their prior interests unless creditors receive full value, in a new capital case the source of their interest in the reorganized firm is their new contribution.[73] Under this view, the equityholders' new interest is not retained "on account" of their prior status, thus avoiding a violation of the absolute priority rule.[74]

The court adopted a moderate position, determining that "[t]he fresh capital exception is viable until eliminated by a higher court. . . . [I]t is better judicial policy for [a] [c]ourt to apply the long standing concept . . . until the United States Supreme Court or the Circuit Court of Appeals for the Seventh Circuit rules the exception no longer exists."[75]

In finding that the new value exception remains available to debtors, the court in *In re Henke* made a clever statutory argument in order to

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68. *See, e.g.*, *In re* Greystone III Joint Venture, 102 Bankr. 560 (Bankr. W.D. Tex. 1989); *In re* Snyder, 99 Bankr. 885 (Bankr. C.D. Ill. 1989); *In re* Maropa Marine Sales Serv. & Storage, Inc., 90 Bankr. 544 (Bankr. S.D. Fla. 1988) (Chief Judge Britton expressed doubt that the new value exception survived the enactment of the Code and then determined that, regardless, the exception did not apply); *In re* Henke, 90 Bankr. 451 (Bankr. D. Mont. 1988).

69. *See* cases cited *supra* note 68.

70. *See* cases cited *supra* note 68.

71. 99 Bankr. 885 (Bankr. C.D. Ill. 1989).

72. *Id.* at 888. *See generally* Brief, *supra* note 51, at 17-23.

73. *See* Levin, *Retention of Ownership Interest Over Creditor Objection - How Intangible and Unsubstantial may the Substantial Contribution Be?*, 92 Com. L.J. 101, 104 (1987); Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 Emory L.J. 1009 (1987). This view is defective because it fails to acknowledge that the only reason the equityholders have the opportunity to make this contribution is because of their prior status as equityholders of the debtor.

74. *See In re Snyder*, 99 Bankr. at 888.

75. *Id.* at 888-89. The court also noted that the new value exception is a "deeply engraved concept" and that nothing in the legislative history of § 1129 indicates Congress intended to eliminate the exception. *Id.* at 888.

escape the confining language of section 1129(b)(2)(B)(ii).[76] First, the court noted that the section 1129(b)(2) definition of "fair and equitable" only "includes" the requirements found in subsections 1129(b)(2)(B)(i) and (ii).[77] Because the Code contains a rule of construction that "includes" is not limiting,[78] the court explained that "Congress clearly intended that the examples set forth [in sections 1129(b)(2)(B)(i) and (ii)] are not limiting but rather invite an open-ended approach, such as the exception set forth in *Los Angeles Lumber*."[79] The court wrote that its holding that the definitions of "fair and equitable" found in sections 1129(b)(2)(B)(i) and (ii) are not exclusive was consistent with legislative intent and history, and constituted a practical, desirable, and compatible approach to a Chapter 11 reorganization effort.[80]

In *In re Greystone III Joint Venture*,[81] the largest creditor noted that the availability of the new value exception was questioned in *Ahlers*, and urged the court to rule that the exception was unavailable to permit debtors "to 'buy' their way back into their own cases."[82] The court rejected the creditor's invitation. Otherwise, the court explained, "a perfectly sensible reorganization might founder [sic] for lack of capital infusion from the equity holders, who could hardly be expected to pump new money into a venture if they could not in the process retain an interest in the venture."[83]

The court also determined that, contrary to the Solicitor General's argument in *Ahlers*, the definitions of "fair and equitable" found in

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76. *In re* Henke, 90 Bankr. 451 (Bankr. D. Mont. 1988). Interestingly, Judge Peterson, the author of the *In re* Rudy Debruycker Ranch, Inc., 84 Bankr. 187 (Bankr. D. Mont. 1988) opinion, reversed his prior view that the *Ahlers* decision eliminated the new value exception, as he wrote the *In re Henke* opinion as well.

77. *In re Henke*, 90 Bankr. at 455. 11 U.S.C. § 1129(b)(2) (West 1979) states: "For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements."

78. *In re Henke*, 90 Bankr. at 455 (citing 11 U.S.C.A. § 102(3) (West 1979)).

79. *Id.*

80. *Id.* Concerning legislative intent and history, the court quoted identical House and Senate reports that stated:

> Although many of the factors interpreting "fair and equitable" are specified in Paragraph (2), others, which were explicated in the description of Section 1129(b) in the House report, were omitted from the House Amendment to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to "fair and equitable" treatment of a dissenting class.

Id. at 455 n.3. (citing 124 Cong. Rec. H11,103 at 11,104 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17420 at 17420 (daily ed. Oct. 6, 1978)).

81. 102 Bankr. 560 (Bankr. W.D. Tex. 1989).

82. *Id.* at 572.

83. *Id.* at 573.

sections 1129(b)(2)(B)(i) and (ii) were not exclusive.[84] In a footnote, the court reasoned:

> It is fair to assume that Congress was aware of *Case* when it passed the Bankruptcy Code. That Congress did not expressly codify *Case*'s holding should be of no moment, as the term of art carried with it the judicial glosses that had been placed upon it. What does matter is that the bankruptcy Code did not expressly repudiate *Case*. It is a time-honored principle of statutory construction that legislators are presumed to be aware of judicial glosses placed on prior statutory enactments, and that subsequent amendments and codifications are presumed to have been carried into the new statute unless expressly repudiated. The Bankruptcy Code did not repudiate *Case*, so the [new value exception to] the absolute priority rule should be presumed to still be good law.[85]

Given the courts' numerous approaches to reach a conclusion as to whether the new value exception survived the enactment of the Bankruptcy Code, clearly no "majority" position has evolved. Possibly, lower courts have been forced to creatively breathe new life into the new value exception because they are reluctant to contradict the United States Supreme Court. On the other hand, the lower courts may be basing their decisions on the often-discussed rationale that the practicalities of a successful reorganization dictate such a result. Regardless of why the courts have kept the new value exception available to a debtor or debtors, a colorable argument can be made to support either the elimination or continuation of the new value exception. However, the statutory arguments of the Solicitor General in *Ahlers* are the most consistent with the language of section 1129(b)(2). Yet, to date, the arguments have not carried the day. The next two sections of this Note will, in part, attempt to determine which of the two possible results concerning the availability of the new value exception best comports with the overall framework of the Bankruptcy Code.

IV. The Creditors' Bargain Model

The first step in determining whether the new value exception has a niche in the overall framework of the Bankruptcy Code requires selecting a theoretical framework that provides a unifying vision of the seemingly contradictory objectives of Chapter 11. In what one commentator has

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84. *Id.* at 575.
85. *Id.* at 575 n.20.

termed the "first attempt at a unifying theme,"[86] Dean Thomas Jackson has developed a conceptual model of the bankruptcy process to provide an explanation of the process.[87]

The model is based on the belief that creditors' consensually negotiated, non-bankruptcy entitlements should be recognized in bankruptcy.[88] Noting that no normative theory has been developed under which intercreditor bankruptcy rules could be examined, Jackson has developed what he terms a "creditors' bargain" model of bankruptcy.[89] He argues that bankruptcy should be viewed as a system "designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position."[90]

Jackson first examines what motives both secured and unsecured creditors have to participate in a "government imposed collective asset-distribution system," that is, the bankruptcy process.[91] He suggests the following three benefits accrue to unsecured creditors under such a system: (1) a reduction in strategy costs; (2) an overall increase in the aggregate pool of assets available for distribution; and (3) administrative efficiencies.[92]

A collective system that treats identically all claimants with the same relationship to a debtor has three strategic advantages. First, instead of facing the possibility of recovering an uncertain amount under an "individualistic creditor's remedy system," the creditors receive a sum "certain."[93] Second, when liquidation is inevitable, the strategic costs associated with a race to the courthouse are eliminated.[94] Finally, a collective proceeding reduces variances in recoveries, which is a virtue to risk-averse creditors.[95]

The second benefit of a collective proceeding accruing to unsecured creditors is the increased pool of assets that are available for distribution.[96]

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86. Skeel, *supra* note 2, at 223.

87. *See* Jackson, *supra* note 10.

88. *See id.* at 858.

89. *Id.*

90. *Id.* at 860.

91. *Id.* at 859.

92. *Id.* at 861.

93. *Id.* Jackson emphasizes that the advantage of a collective system is not that it provides, *ex ante*, a fully determinable sum, but that such a system ensures creditors of equal priority will be treated equally.

94. *Id.* For example, C1 and C2 have each loaned D $50,000. D's assets total $60,000. Both creditors know that the first to the courthouse (or to D, to persuade D to pay voluntarily) will collect $50,000, leaving only $10,000 for the "slower" creditor absent a bankruptcy process. *Id.* at 862.

95. *Id.* at 861-62.

96. *Id.* at 864.

The use of individualistic remedies "may lead to a piecemeal dismantling of a debtor's business by untimely removal of necessary operating assets."[97] On the other hand, an organized non-piecemeal bankruptcy process is likely to increase the aggregate pool of assets available for distribution because the structure of the process is coordinated to achieve this objective.[98]

In addition, Jackson explains that a collective proceeding enhances administrative efficiencies.[99] For instance, issues such as the valuation of the debtor's assets and the nature and extent of secured claims arise in virtually every collection proceeding.[100] In a collective proceeding, these costs are pooled, benefiting all involved. Jackson states that at the time of "negotiating" the creditors' bargain, the reduction in expenses "would be viewed as a clear advantage of a collective process."[101]

Jackson contends these benefits make it likely that an unsecured creditor will agree to a collective system as opposed to pursuing individual remedies.[102] He recognizes, however, that no single creditor "would agree to be bound to this collective system unless it were a compulsory system binding all other creditors: to allow the debtor to contract with other creditors on an opt-out basis would destroy the advantages of a collective proceeding."[103]

Although a mandatory collective proceeding would be an expected feature of the "creditors' bargain," it is unrealistic to assume an *ex ante* meeting of the creditors will take place.[104] The creditors could not negotiate such an agreement because a debtor is unlikely to know who its future creditors will be, and the pool of the debtor's creditors will change over time.[105] Jackson reasons that the problem's solution is the federal bankruptcy rules, which make a mandatory collective system available once insolvency has occurred.[106]

The next question is whether secured creditors would agree to be bound by a collective proceeding. Jackson notes that, unlike unsecured

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97. *Id.*
98. *Id.*
99. *Id.* at 866.
100. *Id.*
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.* at 867. Jackson emphasizes that the role of a mandatory collective system should not be overstated because the presence of a bankruptcy system does not mandate its use. He states, "The availability of a mandatory collective system in which distributions are governed by a set of statutory rules is . . . important because it stipulates a minimum set of entitlements for claimants that, in turn, provides a framework for implementing a consensual collective proceeding outside of the bankruptcy process. *Id.*

creditors, fully secured creditors would not benefit directly from the increased aggregate pool of assets or the reduction of strategic costs.[107] Furthermore, because some of the administratively difficult issues, such as the availability of assets and the priorities of competing claimants, already have been negotiated away, secured creditors are not likely to view administrative efficiencies as a reason to adopt a mandatory collective system.[108]

Thus, the unsecured creditors must be willing to make some type of concessions to the secured creditors to entice their participation in a collective proceeding.[109] If forced to participate on a *pro rata* basis with unsecured creditors in a bankruptcy proceeding, the advantages of secured credit would be lost.[110] To ensure the secured creditors' participation, the bankruptcy process must respect the secured creditors' expectations to be paid first from the assets constituting the secured creditors' collateral.[111] A secured creditor has no reason to object to inclusion in a mandatory collective system if "left as well off as before."[112]

Jackson concludes that the mandatory inclusion of secured creditors in a collective system would produce the following net benefits: The unsecured creditor could be made better off, even if the secured creditors' preferential entitlements were respected, and the secured creditor would be no worse off than before.[113] Jackson also suggests that if secured creditors' superior rights are not respected in a collective system, these creditors will transfer their increased risk to the debtor, and to others seeking their funds, in the form of higher interest rates. Conceivably, these rates could escalate to the level of the interest rates demanded by unsecured creditors, depriving debtors of a cheaper source of funds.[114] Thus, according to Jackson, bankruptcy rules must preserve the parties' non-bankruptcy entitlements in order to avoid undesirable external costs.[115]

V. The New Value Exception in Light of the Creditors' Bargain Model

A. The "Traditional" New Value Exception

One commentator recently examined the new value exception in light of Jackson's creditors' bargain model and concluded that the two are

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107. *Id.* at 868.
108. *Id.* at 868-69.
109. *Id.* at 869.
110. *Id.*
111. *Id.* at 869-70.
112. *Id.* at 870.
113. *Id.*
114. *Id.* at 868-69.
115. *Id.* at 871.

irreconcilable.[116] The commentator first focused on the Solicitor General's argument in *Ahlers*.[117] He noted that the new value exception's grant of the exclusive right to the pre-petition equityholders to receive equity in the reorganized firm in return for a fresh capital contribution when all superior classes have not been compensated in full violates the absolute priority rule.[118] This violation of the absolute priority rule is irreconcilable with the creditors' bargain model because it allows lower priority interests to preempt bargained-for superior interests.[119]

The commentator also examined the risk of the contributors receiving an interest in the entity that exceeds their capital contribution.[120] The creditors' bargain is violated if the value of the equity received by an equityholder exceeds the value of the equityholders' contribution.[121] The preservation of the creditors' bargain is directly tied to the courts' ability to accurately value the contribution made and the value of the ownership interest in the reorganized firm granted to the contributor.[122] However, although cash contributions present little challenge, a judge cannot precisely determine the value of the equity granted given the extremely uncertain value of a reorganized company's equity.[123] This inconsistency leads to conflicts with the creditors' bargain model.

Additionally, equityholders' use of the contribution rule violates the creditors' bargain model when reorganization fails.[124] To visit such a result on creditors permits the equityholders, who have little to lose, a gamble at success at the expense of their creditors.[125]

Given these problems, the commentator concluded that Jackson's creditors' bargain model suggests the Supreme Court should have adopted the Solicitor General's position in *Ahlers*, and held that the enactment of the Bankruptcy Code of 1978 abrogated the new value exception.[126]

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116. *See* Skeel, *supra* note 2, at 236-39.

117. *Id. See* Brief, *supra* note 51, at 20-21.

118. *See* Skeel, *supra* note 2, at 236. Essentially, this right is an option that conceivably could have a market value.

119. *Id.*

120. *Id.* Recall that the Court in *Case v. Los Angeles Lumber Products Co.* stated that "participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." 308 U.S. 106, 122 (1939).

121. Skeel, *supra* note 2, at 237 ("The suggestion is that in purchasing a share of the reorganized company, an equityholder has not really received value on account of his or her former status; the equityholder has merely engaged in a quid pro quo transaction.").

122. *Id.*

123. *Id.* at 238.

124. *Id.*

125. *Id.*

126. *Id.* at 239.

B. A Restructured New Value Exception

The new value exception possesses a positive attribute — it provides fresh capital, thus promoting successful reorganizations under certain conditions. This benefit is derived at the cost of violating the creditors' bargain model. However, the circumstances under which the new value exception is made available to equityholders could be altered to reduce the gravity of this violation of the creditors' bargain model.

First, all senior creditors, for the purpose of one vote, would become members of a "superclass." A creditor qualifies as a "senior creditor" if at the time of extending credit to the debtor, the parties agreed that no other creditor would be given a superior priority position upon dissolution of the firm.[127]

Today, the ultimate decision of whether equityholders may benefit from the new value exception rests with a judge. Under the superclass mechanism, the superclass would have this power. Confirmation of a reorganization plan that permits the equityholders to retain an ownership interest in the reorganized firm, yet fails to provide for payment in full of all creditors' claims, would be conditioned upon the superclass's consent to the plan. However, the superclass's power to make this determination without any input from the intermediate creditors is subject to one important limitation — the aggregate value of the superclass's claims would have to exceed the value of the firm.[128] If the superclass did not meet this condition or rejected the reorganization, the court would apply the existing rules, including the absolute priority rule.

The superclass should be given the power to confirm a reorganization plan over the objection of the intermediate creditors because, like Jackson's creditors' bargain model, the mechanism would mirror the parties'

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127. Practically speaking, secured creditors would constitute the "senior class."

128. *See generally* Baird & Jackson, *supra* note 13, at 745. Baird & Jackson question the application of the absolute priority rule when the firm is worth less than the amount the most senior creditor is owed. They note that the threat of a freeze-out of the intermediate creditors is not a serious problem in this situation because if the firm's assets were liquidated in a state foreclosure action, the intermediate creditors may not be entitled to anything because of their priority position. However, in a Chapter 11 case, the firm is being reorganized, not dismembered. *Id.* Accordingly, Baird & Jackson recognize that a freeze-out of the intermediate creditors could occur here because the possibility that the reorganized company will do much better than expected makes the intermediate creditors' right to reach the assets of the debtor before the equityholders worth something. *Id.* In this sense, the superclass mechanism does not fully respect the rights of the intermediate creditors because it fails to take the full value of their claims in account. However, this result is justified based on the following competing interest of Chapter 11 — the promotion of the successful reorganization of the debtor. At some point, this interest must override the "speculative" claims of the intermediate creditors. Under the superclass mechanism, this point is surpassed when the aggregate value of the superclass's claims exceeds the value of the firm.

nonbankruptcy entitlements and bargaining positions.[129] For example, outside of bankruptcy, if secured creditors were to foreclose on a debtor's property and the assets were worth less than the amount owed, the secured creditors would get only those assets. The secured creditors would control the debtor's assets and would be able to convey an interest in the assets to anyone they deem advantageous.[130] Their decision to share the assets with the old shareholders, instead of the intermediate creditors or a third party, suggests that the secured creditors believe it is in their best interest.[131] The superclass mechanism merely grants the superclass a type of control of the process similar to what the superclass enjoys in state foreclosure actions.

At first glance, the superclass mechanism may seem harsh on the intermediate creditors. However, the mechanism merely reflects the power, or lack thereof, of the priority position chosen by the intermediate creditors upon extending credit to the debtor in exchange for a higher rate of interest. However, as a practical matter, when negotiating the terms of an acceptable reorganization plan, the superclass and equity-holders are forced to consider the bargaining position of the intermediate creditors. For instance, a supplier may refuse to deliver supplies unless treated fairly in the reorganization plan.[132]

The advantages of the superclass mechanism are apparent when analyzed in the context of the controversial aspects of the current new value exception. As previously discussed, the current new value exception is inconsistent with the creditors' bargain model because the equityholders' exclusive right to invest fresh capital in the firm allows the equityholders, due to their prior status, to retain value in the form of an "option" to exercise this right.[133] The value inherent in this right stems from the courts' control of the availability of the new value exception. A court decides whether, over the objection of dissenting creditors, the capital contribution is "fresh," necessary, and substantial enough to justify the pre-petition equityholders' equity interest in the reorganized company.

The value of this exclusive right would be greatly diminished under the superclass mechanism because the superclass would now control the right. The equityholders would have to convince the superclass, which

129. *See generally*, Jackson, *supra* note 10, at 858.

130. *Id.*

131. *Id.*

132. *See, e.g.*, *In re* Blackwelder Furniture Co., 7 Bankr. 328 (Bankr. W.D.N.C. 1980) (refusal to continue deliveries); *In re* Ike Kempner & Bros., 4 Bankr. 31 (Bankr. E.D. Ark. 1980) (refusal to deliver shoes to supplier); Baird & Jackson, *supra* note 13, at 760 (analyzing the strength of general creditor bargaining positions in reorganization negotiations).

133. *See supra* notes 114-19 and accompanying text.

would seek to enforce its original "bargain" to the greatest degree possible, that the equityholders' contributions justify their participation in the reorganized company.

The superclass mechanism would also reduce the costs of the uncertainty surrounding the current new value exception. For instance, when parties are unsure how a court will apply a rule, they will take excessive precautions that often produce few desirable social benefits in order to protect their interests.[134] The superclass mechanism could reduce these costs because its framework could provide more predictable results. In analyzing a debtor's financial situation, the parties generally could estimate whether the superclass is able to control the availability of the new value exception. Even if this estimate becomes too difficult, at a minimum the parties are assured that either the superclass or all of the creditors, and not an impartial third party, will control the availability of the new value exception.

Also, the creditors could reduce the costs associated with insuring against the failure of their precautions [135] because the superclass mechanism is a clearer legal regime in which to analyze the risk of losses. The clearer legal regime would also allow the superclass to determine whether the reorganized company is worth more with the continued participation of the equityholders without being forced to account for the possibility that a judge will allow the equityholders to retain an interest in the reorganized firm.[136]

The superclass mechanism could also promote successful reorganizations under circumstances that the current new value exception cannot. For example, allowing the superclass to determine what type of capital it is willing to accept as consideration for the equityholders' interest in the reorganized firm could expand the "money or money's worth" genre of capital required under the current new value exception. One of the reasons the courts have strictly interpreted the "money or money's worth" capital requirement is to protect the creditors from equityholders who offered speculative contributions or promises of future services to escape the confines of the absolute priority rule.[137] Under the superclass mechanism, the superclass could decide at its own risk what types of capital it would accept; there would be no reason for a court to protect the superclass in this situation. Consequently, the superclass would be allowed to recognize the value of continuity of management in a small company, in which the primary asset is often the entrepreneurial skills of the owner

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134. *See* Skeel, *supra* note 2, at 230.

135. *Id.*

136. Brief, *supra* note 51, at 22-23. The Solicitor General made this argument in the context of arguing that the new value exception should be abolished.

137. *See* Skeel, *supra* note 2, at 227.

or owners, and in which there may be no remaining wealth to contribute to the company.[138]

Similarly, a court would no longer have to demand that the equityholders' contributions be "reasonably equivalent" in value to the value of the equityholders' retained interest in the reorganized company. The superclass's consent to a reorganization plan would supercede the original creditors' bargain. Hence, the original creditors' bargain is not violated if the value of the equity received by the equityholders exceeded the value of the equityholders' contribution.

VI. Conclusion

Anchored in the creditors' bargain model, the superclass mechanism gives to the equityholders with one hand what it takes with the other. By allowing the superclass to determine the conditions of the equityholders' continued participation in the reorganized firm, the mechanism liberalizes the current new value exception. No longer will courts be required to guard against the dilution of creditors' rights through the use of speculative contributions by strictly interpreting the prerequisites to continued equityholder participation established in *Case v. Los Angeles Lumber Products Co.*[139] Instead, equityholders will have the opportunity, subject to the consent of the superclass, to exchange their skills, labor, and ideas for continued participation in the reorganization.

On the other hand, the superclass mechanism increases the bargaining power of the superclass, a justifiable result given the size of the superclass's claims compared to the firm's value. Yet all is not lost for the equityholders. Under the superclass mechanism, the equityholders must satisfy only the demands of the superclass. Prudential considerations, however, may require both the superclass and the equityholders to respect the claims of the intermediate creditors.

The benefits of the superclass mechanism closely parallel those of the bankruptcy process defined by Jackson's creditors' bargain model. The senior creditors are treated comparably both inside and outside the bankruptcy system. The intermediate creditors gain similar benefits yet face the same risks. Whether in the bankruptcy arena or not, their bargaining position depends upon the value of the firm in relation to the value of the creditors possessing superior priority rights.

The benefits of the superclass mechanism would also trickle down to everyday debtors. Creditors would be assured that their bargained-for rights of priority would be respected. No longer would the "traditional"

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138. *Id.* at 226. Skeel raised this point while examining the value of labor and firm-specific skills.

139. 308 U.S. 106 (1939).

new value exception eviscerate the absolute priority rule, effectively negating any of the exception's upward influence upon the interest rate on borrowed funds demanded by creditors.

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Reducing the Federal Docket: An Exclusive Administrative Remedy for Prisoners Bringing Tort Claims Under the Federal Tort Claims Act

Willie Free, who is serving a life term in a federal penitentiary, has filed twelve lawsuits in the past two years. Each claim has sought relief under the Federal Tort Claims Act[1] for the alleged destruction of his personal property. Every time his cell has been searched, he has threatened to bring a tort claim against the government. In response to the threats, Judge Posner in *Free v. United States* observed that Free is trying to deter the prison guards from searching his cell, and is trying to obtain replacements for personal property at the government's expense.[2] In his last complaint, Free alleged that during a shakedown search of his cell, prison guards either negligently or intentionally destroyed some of his personal items including toothpaste, baby powder, and a tennis shoe.[3] Free estimated the value of the items to be fifty dollars. The parties consented to have the suit tried before a federal magistrate, and at its conclusion, the federal magistrate found for the United States. Free attempted to appeal this decision by bringing an action in federal district court under the In Forma Pauperis Statute.[4] The district court denied the petition, prompting Free to appeal to the Seventh Circuit Court of Appeals. Judge Posner wrote a colorful opinion denying Free's claim, and expressing a concern about the abuse of the judicial system by prisoner litigants.[5]

I. Introduction

This Note focuses on the problems of prisoner tort litigation in conjunction with the Federal Tort Claims Act (hereinafter F.T.C.A.).[6] *Free v. United States* illustrates the problems of prisoner tort litigation and the compelling need to change the current system. As a solution, this Note proposes that Congress (1) amend the current F.T.C.A. to

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1. 28 U.S.C. §§ 2671-80 (1983).
2. Free v. United States, 879 F.2d 1535, 1536 (7th Cir. 1989).
3. *Id.* at 1535-36.
4. 28 U.S.C. § 1915 (1988). The In Forma Pauperis Statute allows indigent claimants to bring suit in federal court without paying the necessary court filing fees. *See infra* note 51 and accompanying text.
5. *Free*, 879 F.2d at 1535-36.
6. As will be discussed later in detail, the Federal Tort Claims Act is a waiver of immunity by the United States government for torts committed by government employees. The F.T.C.A. allows recovery if any employee of the United States government causes injury, loss of property, personal injury, or death by the negligent or wrongful act or omission while acting within the scope of his office or employment. 28 U.S.C. § 1346 (1988).

preclude prisoners from bringing suit in the federal district courts; (2) create an Office of Prisoner Complaints;[7] and (3) grant authority to the Attorney General[8] to appoint a Claims Officer who would be the director of the newly created Office of Prisoner Complaints. The proposed Office of Prisoner Complaints would provide an impartial and equitable outcome for prisoner tort claimants, unlike a solution that delegates authority to the Bureau of Prisons to render a final determination of prisoner tort claims.[9]

Habeas corpus[10] and civil rights[11] claims exceed the scope of this Note. Although judges, scholars, and practitioners have suggested that these areas of prisoner litigation are ripe for reform, the Supreme Court has repeatedly emphasized that these actions are fundamental to the scheme of the United States Constitution.[12]

II. The Federal Tort Claims Act in Conjunction with Federal Prisoner Tort Claims

A. *An Historical Background of the F.T.C.A.*

The United States government once held what Justice Frankfurter described as a "privileged position" of "legal irresponsibility" for torts

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7. As discussed *infra*, in Section IV(B) the Office of Prisoner Complaints would be an independent agency established to provide an unbiased exclusive remedy for prisoner tort claimants.

8. The Attorney General would be the natural choice to appoint the Claims Officer because the F.T.C.A. already confers power to the Attorney General to settle tort claims. The Attorney General would simply be delegating authority to the Claims Officer. *See* 28 U.S.C. § 2677 (1988).

9. *See infra* notes 66-84 and accompanying text. As is apparent, the Bureau of Prisons would have difficulties rendering an unbiased decision because the prisoner's claim would involve its own prison officials.

10. The writ of habeas corpus is the essential remedy to safeguard citizens against imprisonment in violation of their constitutional rights. Darr v. Burford, 339 U.S. 200 (1950). "The Privilege of the Writ of Habeas Corpus shall not be suspended unless when in Cases of Rebellion or Invasion the public Safety may require it." U.S. Const. art. I, § 9, cl. 2.

11. Civil rights claims include: "Every person who, under color of any statute, ordinance, regulation, custom or usage of any State . . . subjects, or causes to be subjected, any citizen of the United States or any person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress." 42 U.S.C. § 1983 (1988). *See* Bivens v. Six Unknown Named Agents of the Fed. Bureau of Narcotics, 403 U.S. 388 (1971) (unreasonable search or seizures violating the fourth amendment may give rise to tort action against a federal official). The federal government is liable for civil rights violations occurring under the fourth amendment as discussed in *Bivens*, whereas civil rights actions outside the fourth amendment apply only to state and local government officials.

12. *See* Wolff v. McDonalds, 418 U.S. 539, 579 (1974); Johnson v. Avery, 393 U.S. 483, 485 (1969).

committed by government employees.[13] In 1946, Congress enacted the F.T.C.A. to provide a judicial remedy for private citizens injured by the negligence or misconduct of United States government employees.[14] Before the passage of the F.T.C.A., the doctrine of sovereign immunity was an insurmountable obstacle to plaintiffs seeking to bring tort suits against the United States.[15] The only remedy available to victims of a government tort was to submit a bill of private relief to Congress in the hope that it would receive sympathetic consideration and that they would pass it.[16]

After more than a century of legislative deliberation in developing a strategy to provide a remedy for those who suffered because of the wrongful conduct of federal employees,[17] Congress finally responded after a New York City catastrophe injured thousands of people and caused extensive damage.[18] The F.T.C.A., by its terms, retroactively applied to all tort claims occurring on or after January 1, 1945, thus providing a remedy for the victims of the calamity.[19]

The F.T.C.A is not a complete waiver of governmental immunity. Adjudication of tort claims within the scope of the F.T.C.A. must be tried by federal district court judges or federal magistrates.[20] Also, Congress

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13. Keifer v. Reconstruction Fin. Corp., 306 U.S. 381, 388 (1939).

14. 28 U.S.C. § 1346 (1988).

15. "[N]o suit can be brought against the United States . . . . Even when suits are authorized, they must be brought only in designated courts." United States v. Shaw, 309 U.S. 495, 500-01 (1940). Also, the Supreme Court in State of Minn. v. United States, 305 U.S. 382, 388 (1939) stated: "[I]t rests with Congress to determine not only whether the United States may be sued, but in what courts the suit may be brought."

16. 1 L. Jayson, Handling Federal Torts Claims § 52 (1990). Because of this exclusive relief through private legislation, Congress found itself under an intense and time consuming burden of attempting to adjudicate claims. *Id.* President Fillmore even asserted that the private relief remedy was a "growing evil resulting in the denial of justice and at times even in the ruination of claimants." *Id.* at 2-7.

17. For legislative history showing the congressional purpose behind the adoption of a general tort claims act, reference should be made to the *Hearings Before the Joint Committee on the Organization of Congress*, 79th Cong., 1st Sess. 4, pts 1-4, 67-69, 95, 218-19, 241, 341, 598, 696-97, 907 (1945).

18. On the morning of July 28, 1945, a United States Army bomber, flying in dense fog, struck the Empire State Building. The crash caused the death or serious injury of numerous people and extensive property damage. At that time, no judicial remedy was available to the victims of that crash. Twelve months later, Congress responded by passing the Federal Tort Claims Act. 1 L. Jayson, *supra* note 16, § 51.

19. The dominant objectives of the statute were to relieve Congress of the burdens and pressures of private relief bills and to do justice to those who suffered injuries or losses through the wrongs of government employees. 1 L. Jayson, *supra* note 16, § 51.

20. Magistrates are such an integral part of the district court that if both parties agree, an F.T.C.A. suit instituted in a district court may be tried by a magistrate in accordance with the provisions of the Federal Magistrates Act. Thus, magistrates handle a number of tort claims brought in federal court. *See* Phillips v. United States, 792 F.2d 639 (7th Cir. 1986); 28 U.S.C. §§ 631-636 (1988).

has limited application of the Act by excluding certain categories of claims from recovery.[21] To the extent that a claim falls outside the scope of the act or within its limitations or exceptions, a district court has no jurisdiction over it.[22]

B. The F.T.C.A. in Conjunction with Federal Prisoner Claims

Prior to 1963, the district courts were closed to prisoners in federal penal institutions with respect to tort claims.[23] The following quote explains why judges were reluctant to allow prisoners to recover damages through tort claims.

> Courts assigned several reasons for refusing the prisoners to recover. It was said that to open the courts to prisoners confined in federal penal institutions who wish to assert that they had been injured by the negligence of government employees charged with their detention might be detrimental to the maintenance of discipline.[24]

However, in 1963, the Supreme Court in *United States v. Muniz*[25] decided that a federal prison inmate claiming injury as a result of the negligence of prison officials should not be barred from suing the United States

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21. The following is a partial list of claims which have been excluded:

> (1) claims arising out of the loss or miscarriage or negligent transmission of letters or postal matters;
> (2) claims arising in respect of the assessment or collection of any tax or customs duty;
> (3) claims of persons in the military forces for injury received in the line of duty or for which relief is provided by other law;
> (4) claims for injury or death of a prisoner;
> (5) claims arising out of assault, battery, false imprisonment, false arrest, malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit or interference with contract rights; and
> (6) claims based upon the performance or failure to perform a discretionary function or duty on the part of a federal agency or employee, whether or not the discretion involved be abused.

28 U.S.C. § 2680 (1988).

22. *See, e.g.*, Strick Corp. v. United States, 625 F.2d 1001, 1010 (Ct. Cl. 1980); Maltais v. United States, 439 F. Supp. 540, 547 (N.D.N.Y. 1977).

23. W. Wright, The Federal Tort Claims Act 29 (1959).

24. *Id.* A parallel can be drawn to Congress's decision to exclude servicemen and prisoners from recovering under the F.T.C.A. With the military, Congress feared that such a remedy would be disruptive of the chain of command that is crucial to the functioning of the military.

25. 374 U.S. 150 (1963) (prisoners allowed to bring suit under the F.T.C.A. for the first time). On remand, *see* Muniz v. United States, 280 F. Supp. 542 (S.D.N.Y. 1968) (denying recovery because of failure to establish negligence).

under the F.T.C.A. simply because of his status as a prisoner.[26] Since that time, federal prisoners have been allowed to bring their tort claims in federal district court.

The F.T.C.A., as it relates to prisoners, requires an inmate who desires recovery for a tort claim first to submit a claim, regardless of its amount, to the Bureau of Prisons.[27] The Director of the Bureau of Prisons has the authority to actually settle the dispute.[28] However, the Director re-delegates this authority to the Regional Counsel when the claim exceeds $2,500.[29]

The first step in the administrative procedure is informal resolution.[30] The prisoner and a prison staff member attempt to resolve the

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26. *Muniz*, 374 U.S. at 164-66.

27. In an effort to reduce the number of claims brought under the F.T.C.A., Congress amended the Act in 1966 to require an exhaustion of the administrative process before suit could be brought in federal court. The amended statute provides that no suit may be brought until after the appropriate agency has issued a final denial. The Bureau of Prisons's administrative remedy procedure is contained in Claims Under the Federal Tort Claims Act, 28 C.F.R. § 543.30-.32(1989).

28. 28 C.F.R. § 14.1-.11 (1989). The Director of the Bureau of Prisons is delegated authority by 28 C.F.R. §§ 0.96 and 0.172 (1989) to consider, ascertain, adjust, determine, settle, and pay the tort claims as long as the compromise does not exceed $2,500. The prison staff provides the necessary forms for inmates who wish to file a claim. These forms are then submitted to the Regional Office in the region where the basis for the claim occurred and are ordinarily investigated locally or in the location where the claim occurred. The Warden must designate a staff member to act as an investigating officer.

29. Claims Under the Federal Tort Claims Act, 28 C.F.R. § 543.31 (1989).

30. Claims Under the Federal Tort Claims Act, 28 C.F.R. § 543.31 (1989) establishes the following procedures:

(a) Staff shall provide the necessary forms to an individual who wishes to file a claim.

(b) Claims are to be submitted first to the Regional Office in the region where the basis for the claim occurred. *See* 28 C.F.R. § 503.

(c) Claims are ordinarily investigated locally (where the basis for the claim occurred).

(d) The Warden shall designate a staff member to act as Investigating Officer.

(e) The Warden shall submit the Investigative Report, with the Warden's recommendations, to Regional Counsel. The Regional Counsel shall consider the merits of the tort claim, and is authorized to propose to the claimant a settlement not to exceed $500 or to otherwise dispose of the claim.

(f) If the appropriate disposition appears to be a settlement offer in excess of $500, Regional Counsel shall forward the claim, as well as the institutional and regional recommendations to the Office of General Counsel. The General Counsel shall consider the merits of the tort claim and is authorized to propose a settlement to the claimant not to exceed $2500 or to otherwise dispose of the claim.

(g) Either the Regional Counsel or General Counsel may deny any claim filed under the Federal Tort Claims Act regardless of the amount of the claims.

dispute.[31] If this informal process fails, the inmate files a formal written complaint on the appropriate form.[32] Thereafter, if the inmate is not satisfied with the Warden's response to the initial complaint, the inmate may appeal to the Regional Director within twenty calendar days of the date of the Warden's response.[33] After the Regional Director issues the final disposition, if the prisoner claimant is unsatisfied with the result, the prisoner may appeal to the General Counsel within thirty calendar days from the date of the Regional Director's response.[34] The General Counsel's denial of the claim will constitute a final administrative denial.[35] Thereafter, the prisoner has the right to bring suit in federal district court.

These procedures have been explained in detail because the administrative remedy proposed by this Note, as will be discussed later, still requires the administrative process to be exhausted.

III. Problems with the Federal Tort Claims Act and the Growing Federal Docket

A. The Scope of the Problem

The United States federal courts are burdened by the staggering number of cases pending on the federal dockets. Between September 30, 1987 and September 30, 1988, there were 69,062 diversity filings and 39,732 prisoner petitions.[36] During the 1980s, prisoner litigation probably represented the largest increase in case filings in the federal judiciary.[37]

Judges in the 1940s and 1950s denied prisoners the right to bring tort suits against prison officials because of the fear of potential discipline problems that would be created inside the prisons.[38] Their concerns were warranted. The following comment is a prime example of how some federal prisoners abuse the judicial process:

> Since no human being could really generate more than 554 causes of action in one lifetime, one would assume that many of Green's

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The denial of a claim constitutes a final administrative action.

(h) Staff shall attempt to make a claim determination within six months from the date of filing. If a final disposition is not made within the six month period, the claimant may assume that the claim is denied. The denial of a claim constitutes a final administrative action. An individual whose claim is denied may elect to institute a suit upon denial of that claim.

31. W. Wright, *supra* note 23, at 38-40.
32. *Id.*
33. Claims Under the Federal Tort Claims Act, 28 C.F.R. § 543.31 (1988).
34. *Id.*
35. *Id.*
36. Free v. United States, 879 F.2d 1535, 1537 n.1 (7th Cir. 1989).
37. *Id.* at 1538.
38. W. Wright, *supra* note 23.

> filings have been purely repetitions of previous suits. . . . In addition, most courts have found them frivolous, irresponsible and unmeritorious . . . and some have been found to be malicious and in bad faith as well. . . . One court suggested that by swamping the court with frivolous suits, Green somehow hoped to force his own release from custody. . . . Another considered it a scheme to impede the judicial system and bring the court system to a halt.[39]

Many prisoners are interested in using the courts to achieve ends other than the adjudication of meritorious claims. Prisoners use the judicial system to harass prison and judicial officials by pursuing cases to the full limits of the law. Others want the government to pay for their worn out personal items. "These cases are 'typically brought for their nuisance value by persons on whose hands time hangs heavy' and who hav[e] nothing else constructive to occupy their unproductive hours."[40]

In *Tinker-Bey v. Meyers*,[41] the issue was whether the United States government should be liable under the F.T.C.A. for a prisoner's two sweatshirts, pair of tennis shoes, and a pair of pajama bottoms allegedly lost when the prisoner was transferred into disciplinary segregation. The prisoner sought $150 to replace those items. Judge Posner denied the claim, labeling it as "frivolous," and stated "none of the usual inhibitions to bringing suits for trivial or imagined losses weighs on prisoners serving long prison terms."[42] Posner further expressed his frustration over prisoner litigation in *Free* when he stated that "[s]uch [frivolous] suits [filed under the Federal Tort Claims Act] convert the federal courts into small-claims courts and prison lost-and-found departments."[43]

Dollar amounts alone are not sufficient to deem claims frivolous. However, at a time when federal caseloads are bulging, a claim with an extremely small dollar amount does not necessitate attention by a federal judge.[44] These claims should be settled long before they reach the courthouse doors. As Judge Coffey stated in *Free*:

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39. J. Anderson, Curbing the Abuses of Inmate Litigation 14 (1986) (quoting Green v. Arnold, EP-80-CA33 (W.D. Tex. 1981) (unpublished opinion)).

40. *Free*, 879 F.2d at 1540 (quoting Savage v. CIA, 826 F.2d 561, 563-64 (7th Cir. 1987)).

41. 800 F.2d 710 (7th Cir. 1986).

42. *Id.*

43. 879 F.2d at 1536.

44. The goal of many prisoners is to continue to torment the judges who put them in jail in the first place. In *Tinker-Bey*, Judge Posner provided another example of abusive prisoner litigation: "Another inmate sued for the value of an 'Afro pick' and refused a settlement offer of $2." 800 F.2d at 710.

> While there is no dispute that prison inmates are entitled to relief in a court of law for true violations of their constitutional rights, I do believe it is becoming more evident every day that the efficient administration of justice is not served with the filing of highly questionable complaints alleging constitutional violations intermingled with the loss of various articles of clothing . . . .[45]

B. The Increase in Prisoner Litigation in Conjunction with the F.T.C.A.

Several reasons exist for the dramatic increase in federal prisoner litigation over the past twenty years. Supreme Court decisions in the 1960s and 1970s account for a large portion of this increase. In *Younger v. Gilmore*,[46] the Supreme Court held that the United States must protect prisoners' right of access to the courts by providing them with law libraries or alternative sources of legal knowledge.[47] The Supreme Court went a step further in *Bounds v. Smith*[48] when it decided that "the fundamental constitutional right of access to the courts requires prison authorities to assist inmates in the preparation and filing of meaningful legal papers by providing prisoners with adequate law libraries or adequate assistance from persons trained in the law."[49]

Another reason prisoners continue to bring vexatious litigation is because the F.T.C.A. is inundated with flaws; thus, prisoners exploit the deficiencies and file numerous claims. A significant problem is that no minimum amount in controversy is required to file an action under the F.T.C.A. Federal prisoners may bring claims in federal court regardless of the dollar amount or type of dispute.[50] In addition, the increase in federal prisoner litigation has occurred because the F.T.C.A., in conjunction with the In Forma Pauperis Statute, provides prisoners, *at no cost*, the opportunity to bring tort actions repeatedly in federal court to redress acts allegedly committed by federal prison officials.

The In Forma Pauperis Statute[51] allows inmates to file civil or criminal claims in federal court without prepaying filing costs so long as they

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45. 879 F.2d at 1539-40 (Coffey, J., concurring).

46. 404 U.S. 15 (1971) (affirming Gilmore v. Lynch, 319 F. Supp. 105 (N.D. Cal. 1970)).

47. *Id.*

48. 430 U.S. 817 (1977).

49. *Id.* at 828 (footnote omitted). As will be discussed *infra* Section V(A), a tort claim is not considered to be a fundamental right; thus, the Constitution would not require federal courts to entertain prisoners' tort claims or dictate that prisoners be afforded the right to bring suit in a federal court.

50. *See, e.g.*, Free v. United States, 879 F.2d 1535 (7th Cir. 1989); Tinker-Bey v. Meyers, 800 F.2d 710 (7th Cir. 1986).

51. 28 U.S.C. § 1915 (1988).

file an affidavit, in good faith, stating their inability to pay the costs of the lawsuit.[52] Significantly, unlike a paying litigant, an inmate filing an in forma pauperis claim lacks any monetary incentive to refrain from filing malicious or repetitive lawsuits.[53] Congress, in order to prevent abusive or frivolous litigation, enacted section 1915(d) of the In Forma Pauperis Statute authorizing federal courts to dismiss claims filed by prisoners in forma pauperis if the claims are frivolous or if the court is satisfied that the allegations of poverty are untrue.[54] Although federal judges can review frivolous claims quickly and dismiss them sua sponte, the docket continues to be burdened with repetitive federal inmate claims. As Chief Justice Rehnquist stated in his dissent in *Cruz v. Beto*,[55] "The inmate stands to gain something and lose nothing. . . . Though he may be denied legal relief, he will nonetheless have obtained a short sabbatical in the nearest federal courthouse."[56] Indeed, the Supreme Court has recognized that meritless in forma pauperis complaints impede efficient judicial administration.[57]

The In Forma Pauperis Statute, recent case law requiring mandatory access to the courts, and the deficiencies in the F.T.C.A. have resulted in an overwhelming amount of prisoner litigation placed on federal court dockets. Unfortunately, this litigation tends to be unmeritorious and serves only to burden the federal courts.

In conclusion, the federal court system should not serve as a dumping ground for prisoners' frustrations. Judges, as well as taxpayers and other litigants, suffer as a result of the repetitive and abusive litigation. Other litigants are pushed back in the line for adjudication of their claims when numerous frivolous claims or minor disputes[58] continue to saturate the docket. The public must bear the burden of paying higher taxes for the prisoner litigants who file in forma pauperis. Moreover, prisoners themselves may suffer if the current abuse is not halted. As the court in *Green v. Wynick* stated, "[I]t is common sense that conscientious

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52. *Id.*

53. "Congress recognized, however, that a litigant whose filing fees and court costs are assumed by the public, unlike a paying litigant, lacks an economic incentive to refrain from filing frivolous, malicious, or repetitive lawsuits." Neitzke v. Williams, 109 S. Ct. 1827, 1831 (1989).

54. 28 U.S.C. § 1915(d) (1988).

55. Cruz v. Beto, 405 U.S. 319, 327 (1972) (Rehnquist, J., dissenting).

56. *Id.* at 326-27 (Rehnquist, J., dissenting).

57. *Neitzke*, 109 S. Ct. at 1832.

58. Minor disputes are deemed minor only in the sense that they are of little monetary worth. Often, the prisoner is suing to establish a principle, and is unconcerned about the actual loss he has incurred. This Note argues that minor disputes do not deserve federal district court attention; instead, these types of disputes command an exclusive administrative remedy.

recognition of prisoner rights can continue only as long as the process is not abused by the prisoners to the extent that renders it meaningless. We are coming dangerously close to that time."[59] Furthermore, as Judge Coffey stated in *Free*:

> Given the tremendous increase in prisoner cases in the federal courts and the projected increase in prisoner population, as well as the vast amount of court time directed toward the imposition of these appeals that could be used to address other, more substantial controversies, singling out prisoners' unmeritorious small tort claims for relegation to an administrative remedy is clearly a logical step toward reducing the caseload of the federal judiciary . . . .[60]

Thus, as this Note advocates, Congress should revise the F.T.C.A. to preclude prisoners from the federal courts and to establish an independent administrative remedy.

IV. The Proposal of an Impartial, Equitable, but Exclusive Administrative Remedy

A. The Current Remedy for Prisoner Tort Claims

The early tort claims bills of the 1920s and 1930s considered an administrative mode for governmental tort liability.[61] The bill finally enacted (the F.T.C.A.) adopted a judicial mode for disposition of tort claims.[62] Congress vested decisional authority in the federal courts and agencies to dispose of tort claims.[63] In 1966, Congress amended the F.T.C.A. to require claimants to exhaust the administrative process before filing in the federal courts, which thus demonstrates that Congress intended and encouraged agencies to dispose of tort claims.[64] "If the original act was designed to ease the burdens of Congress by shifting primary responsibility for government tort claims to the courts, the 1966 amendments sought to transfer the burden to the agencies."[65] Thus, Congress recognized, at that time, the need for agency resolution. The

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59. Green v. Wyrick, 428 F. Supp. 732, 735-36 n.4 (W.D. Mo. 1976) (quoting Green v. Garrot, Misc. No. 76-8184 (8th Cir., Nov. 2, 1976)).

60. 879 F.2d at 1540 (Coffey, J., concurring).

61. Bermann, *Federal Tort Claims at the Agency Level: The FTCA Administrative Process*, 35 Case W. Rev. 509, 529 (1985).

62. *Id.* at 529.

63. *Id.*

64. *Id.* at 520.

65. *Id.* at 531.

current F.T.C.A. must be modified in order to reduce the federal workload, to decrease the number of frivolous and minor claims, and to provide an impartial and equitable remedy for federal prisoners. Accordingly, this Note proposes that Congress should (1) revise the F.T.C.A. to preclude federal prisoners from bringing their claims in federal district court; (2) enact a subsequent statute to establish an Office of Prisoner Complaints; and (3) allow the Attorney General[66] to appoint an official (Claims Officer) to establish the Office of Prisoner Complaints.

B. The Proposal: The Office of Prisoner Complaints

The concept of an Office of Prisoner Complaints is modeled after ombudsman laws that have existed in Scandinavia since 1713[67] and in the United States since the 1960s.[68] In Scandinavia, "[t]he Ombudsman is an officer of Parliament who investigates complaints from citizens that claim they have been unfairly dealt with by government departments and who, if he finds that a complaint is justified, seeks a remedy."[69] In the United States, Hawaii, Nebraska, and Iowa have enacted ombudsman legislation with similarities to the Scandinavian Ombudsman.[70]

Unlike this Note's proposal, state ombudsman statutes grant power to the Ombudsman *only* to make recommendations and to publish reports that serve merely to embarrass public employees; whereas, the proposal of this Note is to grant a public official (hereafter a Claims Officer) the power to make *binding* decisions.[71] Thus, the proposed statute requires that if the Claims Officer finds that a prison employee is guilty of any wrongdoing, the Bureau of Prisoners will be responsible for paying estimated damages caused by the employee or employees as determined by the Claims Officer. The prisoner will be unable to appeal the Claims Officer's decision in a federal court. The remedy is exclusive and final.

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66. As the Federal Tort Claims Act already authorizes the Attorney General to settle claims, theoretically the Attorney General would be delegating authority to another official responsible for prisoner tort claims; thus, the proposed Office of Prisoner Claims would be an extension of the Attorney General's office. *See* 28 C.F.R. § 14.10 (1988).

67. In 1713, Sweden created an Ombudsman Office. It was the first country to establish such an office. The Ombudsman Office's function was to exercise general supervision over public servants to ensure that the laws and regulations were being complied with and they were discharging their duties properly. Rudholm, *The Chancellor of Justice*, in THE OMBUDSMAN 17 (D. Rowat ed. 1965).

68. Hawaii, Nebraska, and Iowa have patterned statutes after ombudsman legislation. *See* Frank, *State Ombudsman Legislation in the United States*, 29 U. MIAMI L.R. 397, 398 (1975). The proposal of this Note differs substantially from these statutes.

69. ROWAT, THE OMBUDSMAN 7 (D. Rowat ed. 1965).

70. Frank, *supra* note 68, at 398. *See also* HAWAII REV. STAT. §§ 96-1 to 96-19 (Michie 1988 & Supp. 1990); 21 IOWA CODE ANN. §§ 601G.1-.23 (West 1988); NEB. REV. STAT. § 81-8240 (1987).

71. *See* Frank, *supra* note 68, at 435.

To attain the goal of rendering unbiased, fair, and quick resolutions of prisoner tort claims, the Attorney General will appoint a Claims Officer recognized for wise judgment, objectivity, and integrity, who will be responsible for establishing the Office of Prisoner Complaints. The Claims Officer need not be an attorney, but must be well-equipped to analyze administrative and legal issues. Her term will be set for a number of years to ensure isolation from the political process.[72] Moreover, in order to conduct a fair and thorough investigation of the federal prisoners' tort claims, she will need to be empowered with the tools to deal with the federal prison personnel and the Bureau of Prisons — the agency ultimately responsible for paying the claims.[73] In order to carry out the goals of the Office of Prisoner Complaints, the Claims Officer must have the following power:

(1) To appoint a Deputy Claims Official who will serve as the acting director when the Claims Official is unavailable. The Deputy will be expected to possess the same qualifications as the Claims Officer.[74]

(2) To control the selection and retention of the staff.[75]

(3) To delegate authority to the staff.[76]

(4) To make rules and regulations for conducting investigations.

(5) To receive complaints from federal prisoners, investigate those claims, make findings, and report findings to the respective prisons.[77]

(6) To subpoena any person to appear to give sworn testimony, or produce documentary or other evidence that is necessary for

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72. The Claims Officer will serve for a number of years in order to be shielded from political pressures. This is modeled after the federal judiciary in which federal judges are given a life term to serve in order to remain a non-political entity. A long term is desirable to permit the Officer sufficient time to become proficient at the attendant duties; to provide a measure of independence from politics; and to provide prestige and security to attract qualified people to the position. To ensure the accountability that is desired, an excessively long term would not be recommended. Frank, *supra* note 68, at 413.

73. Again, this proposed Office is patterned after the Ombudsman Statute. *See* Frank, note 68, at 423.

74. Patterned after the Ombudsman Statute, the appointment of a Deputy by the Claims Official is compulsory. Frank, *supra* note 68, at 410-11. The Deputy will be the acting official when the Claims Officer is unavailable. Thus, it would be essential for the Deputy to possess all of the same qualities as the Claims Officer.

75. The Claims Officer, by selecting the staff, can then ensure the accountability and impartiality that is required for this Office.

76. The Claims Officer will be responsible for explaining the actual findings and reports that will be sent to the Bureau of Prisons. This ensures the accountability and integrity of the office because employees, unlike the Claims Officer, will not necessarily be required to have all of the qualifications as the Claims Officer.

77. The Ombudsman will be responsible for setting up procedures for the prisoners to follow, *e.g.*, forms to complete and deadlines for claims.

the investigation.[78]

(7) To participate and cooperate with the Bureau of Prisons' personnel in such conferences as might lead to improvements in the functioning of the prisons.

(8) To bring suit in district court to force the prison authorities to cooperate or to enforce the provisions of the Office.

(9) To hold hearings that will require mandatory attendance of the parties.[79]

Importantly, the proposed procedure for federal prisoners bringing tort claims under the amended F.T.C.A. will still require federal prisoners to exhaust the current Bureau of Prisons administrative process. However, upon receiving a final denial from the Bureau of Prisons, instead of allowing an appeal to the federal courts, prisoners will be restricted to filing their claims with the Office of Prisoner Complaints.

Upon receipt of a prisoner tort claim, the Claims Office will inform the respective prison authorities that an investigation is being conducted. At that point, the prison officials, as discussed briefly above, will be obligated to cooperate,[80] and any records or documents that the prison authorities possess will be subject to review.[81] If the Claims Officer determines that a hearing[82] will enhance an understanding of the facts of the case, all parties will be obligated to attend.

Before reaching a conclusion that is adverse to the federal prison, the Claims Officer will be required to consult with the prison officials, if the Officer has not already done so while conducting the investigation, and to provide the prison officials with an opportunity to respond to the allegations. This process minimizes any bias or oversight the Claims Officer may have formed during the investigation. Upon a finding that prison officials committed a tort as alleged by the prisoner, the Bureau of Prisons will be obligated to perform the requirements that the Claims

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78. The power to subpoena serves as a legal device to compel persons to appear or produce evidence because of the threat of legal sanctions for non-cooperation. This is an essential power of the Claims Officer so that the necessary evidence can be gathered in order to render an equitable result.

79. The word "hearing" refers to an administrative agency hearing and would require compliance with administrative procedures. The Ombudsman Statute omits the word "hearing."

80. Failure to cooperate will require the Claims Officer to file suit in federal district court to enforce compliance by the prison officials.

81. Limitations will be placed on the examination of confidential documents and records of the Bureau of Prisons. Frank, *supra* note 68, at 424.

82. If the Claims Officer determines that a hearing is necessary, all of the procedures for an *administrative* hearing must be followed.

Officer outlines.[83] In addition, if she determines that insufficient evidence exists to find for the prisoner claimant, the Claims Officer will have an obligation to explain the decision to the prisoner. This will help to ensure objectivity and accountability in the process.

The foregoing description of the exclusive administrative remedy proposed by this Note demonstrates that the Office of Prisoner Complaints is designed as a system to provide federal prisoners with an equitable determination of their tort claims without resorting to the federal courts. The current administrative process which channels complaints through the Bureau of Prisons lacks the independence and impartiality that is required for an exclusive equitable outcome. For example, as previously discussed, the Warden of the Prison or a prison official who has been given authority determines the outcome of the prisoner's claim. Obviously, the Warden has a bias against awarding money to prisoners for claims committed by the prison's employees. The Warden may have a legitimate fear that if the prisoner is awarded damages, the prison would be disrupted and the Warden's decision would prompt more prisoners to bring claims against the prison officials.

C. The Legitimacy of An Office of Prisoner Complaints

The proposed Office of Prisoner Complaints will relieve the federal courts of minor and frivolous prisoner tort claims and, at the same time, offer federal prisoners a fair remedy. Although courts currently play a major role in correcting abuses by prison officials, judges do not have time to monitor the prison system. With the extensive power and discretion given to the prison officials today, the Claims Officer, unlike a federal court, will have the time, power, and authority to target prison abuses and to investigate complaints more thoroughly.

> At the present time it is extremely difficult in many situations to uncover the policies, objectives, and procedures of administrative agencies. . . . The mere availability of the knowledge will make it possible for society's leaders to come to grips with some of the basic policy problems that will inevitably demand re-evaluation.[84]

Therefore, the Claims Officer will be able to pinpoint the repetitive or frivolous claims brought by prisoners, and rapidly dispose of them.

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83. Under the Scandinavian Ombudsman Statute and state models, the Claims Officer has no power to give orders or make decisions. The Claims Officer's function is simply to issue recommendations in the report. However, under the type of administrative scheme that is to be established, it is essential that the prison, if found to have committed a tort, provide a remedy to the prisoner. Frank, *supra* note 68, at 398.

84. Nader, *Ombudsmen for State Governments*, in The Ombudsman 243 (D. Rowat ed. 1965) (quoting Pierce, *Symposium on the Model State Administrative Procedure Act: "The Act as Viewed by an Academician,"* 16 ADMIN. L. REV. 51 (1963).

The Office of Prisoner Complaints also will serve to reduce litigation costs, relieve taxpayers burdened by in forma pauperis claimants, decrease litigation time for other litigants affected by frivolous claims, and reduce the federal docket. Prisoners will be afforded relief for their legitimate claims and will not continue to burden the federal courts with minor or frivolous litigation. This Note urges Congress to adopt this proposal establishing an Office of Prisoner Complaints.

V. The Constitutionality of an *Exclusive* Administrative Remedy for Prisoner Tort Claims

Any attempt to restrict a federal prisoner's access to the federal courts would have to comport with the Constitution — the supreme law of the land.[85] This Note acknowledges that at least three constitutional concerns are raised by the proposed statute. A cursory discussion[86] of these problem areas, however, reveals that the Constitution is not violated by the proposal.

A. Restricting the Jurisdiction of the Federal Courts

The first constitutional issue raised is Congress's authority to remove prisoner tort claims from the jurisdiction of the federal judiciary. The jurisdiction of the federal courts is contained within article III of the United States Constitution.[87] Jurisdiction of the courts to hear a case or controversy can be examined in three components: original jurisdiction in the Supreme Court, appellate jurisdiction in the Supreme Court, and both original and appellate jurisdiction in the lower federal courts.[88] The full scope of the original jurisdiction of the Supreme Court is set forth in article III of the United States Constitution.[89] Congress may neither expand nor contract the list of cases in the Supreme Court's original jurisdiction.[90] Because article III does not include prisoner tort claims, Congress may eliminate entirely the right of a prisoner to sue in federal court without running afoul of the Supreme Court's original jurisdiction.

The appellate jurisdiction of the Supreme Court extends to all cases over which the Court lacks original jurisdiction.[91] However, the Con-

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85. *See* Marbury v. Madison, 5 U.S. (1 Cranch) 137, 173-80 (1803).

86. Despite the acknowledged importance of the United States Constitution, it is beyond the scope of this Note to provide a complete analysis of the constitutional issues raised by the proposal. Instead, this Section simply recognizes those areas that are most troublesome and provides a brief analysis of the constitutional concerns.

87. U.S. Const. art. III, §§ 1-2.

88. *See* U.S. Const. art. III, §§ 1-2.

89. U.S. Const. art. III, § 2, cl. 2.

90. Marbury v. Madison, 5 U.S. (1 Cranch) 137 (1803).

91. U.S. Const. art. III, § 2, cl. 2.

stitution permits Congress to limit this jurisdiction.[92] Although Congress's ability to carve out exceptions is not without some constitutional limitations,[93] it seems fairly clear that Congress could constitutionally remove prisoner tort claims entirely from the jurisdictional reach of the Supreme Court.

Although the first act of Congress was the creation of the inferior federal courts,[94] the Constitution does not specify the scope of their jurisdiction, nor does it even require that Congress create them.[95] As a result, some courts and scholars have suggested that Congress may restrict the jurisdiction of the lower federal courts in any way it sees fit.[96] In *Quinn v. California Shipbuilding Corp.*, a district court judge stated: "The United States District Court is a court of limited jurisdiction controlled by grants of power through Acts of Congress. . . . That the power to grant jurisdiction to the District Courts includes the power to withdraw jurisdiction is likewise settled."[97] Thus, Congress could remove prisoner tort claims from the jurisdiction of the federal judiciary without violating article III of the United States Constitution.

B. Equal Protection Considerations

The second constitutional issue raised by this Note's proposed statute is the claim that prisoners are being denied equal protection of the laws.[98] Under an equal protection analysis, all laws that make distinctions

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92. *Id.* In *Ex parte McCardle*, the Supreme Court acknowledged that its appellate jurisdictional power was "conferred with such exceptions and under such regulations as Congress shall make" according to article III, section 2, clause II. 74 U.S. (4 Wall.) 506, 513 (1868).

93. *See, e.g.*, United States v. Klein, 80 U.S. (13 Wall.) 128 (1871). In *Klein*, the Supreme Court decided that Congress, in removing from the Court's appellate jurisdiction a case involving a plaintiff who was seeking to use a presidential pardon to recapture his lands seized by the federal government during the Civil War, had exceeded its powers to make exceptions to the Court's appellate jurisdiction. *Id.* at 147-48. *See also* United States v. Brainer, 691 F.2d 691 (4th Cir. 1982); ROWAK, ROTUNDA & YOUNG, CONSTITUTIONAL LAW (3d ed. 1986).

94. The Federal Judiciary Act of 1789, 1st Cong., 1st Sess. (1789).

95. *See* U.S. CONST. art. III, §§ 1-2.

96. Although the Supreme Court has not considered this issue, some scholars take issue with the contention. *See, e.g.*, Amar, *A Neo-Federalist View of Article III: Separating the Two Tiers of Federal Jurisdiction*, 65 B.U.L. REV. 205 (1985).

97. 76 F. Supp. 742, 743 (S.D.C.A. 1947) (Congress withdrawing jurisdiction of the district courts with the Portal-to-Portal Act).

98. Although the right of equal protection embodied in the fourteenth amendment was originally a right that citizens enjoyed only against the several states, the Supreme Court has applied it to the federal government by reading it into the fifth amendment. *See, e.g.*, Bolling v. Sharpe, 347 U.S. 497 (1954) (by reading the equal protection clause into the fifth amendment, the Court applied its decision in Brown v. Board of Educ. to segregated schools in the District of Columbia).

or classifications are subjected to judicial scrutiny. The strength of the judicial scrutiny depends on the characterization of the classification. For example, for certain classifications, including race and alienage, the Court applies strict scrutiny.[99] For others, like gender, the Court applies intermediate scrutiny.[100] For all other types of classifications, the Court applies only low-level scrutiny, often termed the "rational basis test."[101] Prisoners are not a suspect classification.[102] As a result, this Note's proposal need only survive low-level scrutiny. Under this minimal scrutiny, "laws are presumed to be constitutional under the equal protection clause for the simple reason that classification is the very essence of the art of legislation."[103]

A statute will be upheld under minimum scrutiny if it is rationally related to a legitimate governmental interest.[104] Clearly, the reduction of the burgeoning federal court docket is a legitimate governmental interest. Congress has already acted in other ways to try to achieve this reduction.[105] Furthermore, this Note's proposal is rationally related to a governmental interest; by precluding prisoners from filing tort claims in federal court, Congress will be taking a significant step toward reducing the federal docket to a manageable level. Thus, Congress may legitimately enact this Note's proposal without violating the equal protection clause.

C. *Procedural Due Process Analysis*

The last constitutional concern raised by this Note's proposal is procedural due process. Procedural due process requires that no person "be deprived of life, liberty, or property, without due process of law."[106] The first step in any due process analysis is to determine whether the governmental action to which a plaintiff objects constitutes a deprivation of life, liberty, or property. If it does, the next stage is to determine what process is due the plaintiff in order to justify the deprivation. The deprivation involved by the proposed statute is the loss of a prisoner's

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99. *See, e.g.*, Palmore v. Sidoti, 466 U.S. 424 (1984); Korematsu v. United States, 323 U.S. 214 (1944).

100. *See, e.g.*, Craig v. Boren, 429 U.S. 190 (1976); Reed v. Reed, 404 U.S. 71 (1971).

101. *See, e.g.*, Williamson v. Lee Optical Co., 348 U.S. 482 (1955).

102. Moss v. Clark, 886 F.2d 686, 689-90 (4th Cir. 1989) (discussing in some detail the necessary showing required in order to be deemed a suspect class and why prisoners fail to meet that showing). *See also* McGinnis v. Royster, 410 U.S. 263, 270 (1973).

103. City of Cleburne v. Cleburne Living Center Inc., 473 U.S. 432 (1985). *See also* Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307 (1976).

104. McGinnis v. Royster, 410 U.S. 263, 270 (1973).

105. Congress, for example, recently increased the minimum dollar value for diversity cases.

106. U.S. CONST. amend V.

right to sue in federal court for torts committed by a government employee.[107] According to the Supreme Court's analysis in *United States v. Demko*,[108] the proposed Office of Prisoner Complaints does not violate the due process clause.

In *Demko*, the Supreme Court held that a prisoner who was precluded from suing in federal court under the F.T.C.A. for an injury incurred while working within the federal prison was not denied due process of law.[109] In that case, the prisoner's only remedy was the exclusive remedy provided under 18 U.S.C. § 4126,[110] which is basically a workmen's compensation statute for prisoners working in a prison. The *Demko* Court reasoned that compensation laws are substitutes for, and not supplements to, common law tort actions. According to the Court in *Demko*, so long as the government has supplied an administrative compensation remedy that reasonably and fairly compensates the prisoner, no due process violation has occurred.[111]

It thus follows that the proposed administrative remedy will be adequate if the following principles are observed:

> In all instances, the [government] must adhere to previously declared rules for adjudicating the claim or at least not deviate from them in a manner which is unfair to the individual against whom the action is to be taken. The government always has the obligation of providing a neutral decisionmaker — one who is not inherently biased against the individual or who has a personal interest in the outcome.[112]

In this case, prisoners are being deprived of the opportunity to litigate their tort claims in federal court. However, this deprivation is being offset by a reasonable and fair administrative compensation system. Under the analysis used in *Demko*, the enactment of this Note's proposal would not, therefore, constitute an unconstitutional deprivation of property without due process of law.

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107. To the extent that a deprivation of life, liberty, or property may occur in the very commission of the tort, a remedy would be provided by other federal laws (such as § 1983 actions) and the United States Constitution itself. *See, e.g.*, Daniels v. Williams, 474 U.S. 327 (1986).

108. 385 U.S. 149 (1966).

109. *Id.* at 153-54.

110. 18 U.S.C. § 4126 (1988).

111. 385 U.S. at 152.

112. *Id.* at 152. *See also* Rubin, *Due Process and the Administrative State*, 72 CALIF. L. REV. 1044 (1984); Van Alstyne, *Cracks In the "New Property": Adjudicative Due Process in the Administrative State*, 62 CORNELL L. REV. 445, 489 (1977).

Although each of these constitutional "red flags" could be the subject of an entire Note, this Note's short analysis should suffice to demonstrate that the proposed exclusive administrative remedy is not inconsistent with the United States Constitution.

VI. Conclusion

The federal judiciary during the past decade has been flooded by federal prisoner tort litigation. The following reasons account for some of this increase: (1) the F.T.C.A. waives sovereign immunity and allows federal prisoners to sue the government for prison officials' actions; (2) the F.T.C.A. does not require a minimum dollar value for the right to bring the controversy in federal court; (3) a recent Supreme Court holding requires prisons to be equipped with legal assistance and law libraries to provide prison litigants more information about the legal system; and (4) the In Forma Pauperis Statute allows the majority of federal prisoners, indigents, to file claims in federal court without paying the filing court costs. Federal prisoners, with all of these opportunities, are burdening the courts, other litigants, and the taxpayers with frivolous and minor claims. Bored or mischievous prisoners abuse the judicial and prison systems by bringing repetitive and frivolous claims.

This Note proposes that Congress amend the current F.T.C.A. by prohibiting the federal courts from entertaining prisoner tort claims. To replace the federal courts, Congress should establish an Office of Prisoner Complaints to adjudicate the federal prisoners' tort claims after they have exhausted the Bureau of Prisons administrative remedy. Patterned after ombudsman legislation, the Office of Prisoner Complaints, as contemplated by this Note, will provide an impartial, equitable, and quick remedy for federal prisoners allegedly injured by federal prison officials' torts. The Office of Prisoner Complaints, unlike the federal courts, would have the time and resources to target prison guard abuses. The decision of the Office of Prisoner Claims would be final and binding.

The constitutional analysis of this proposal demonstrates that it would pass constitutional muster. First, the United States Constitution grants Congress the power to limit and alter the jurisdiction of the lower federal courts. The equal protection clause is not violated by this proposal because precluding prisoners from the federal docket rationally relates to the legitimate goal of reducing the federal docket. Also, the proposal establishes an equitable procedure for prisoners who have been injured by the government, thus providing prisoners with due process. Therefore, none of the constitutional challenges succeed.

As Judge Posner stated in *Free v. United States*, "At a time of staggering federal caseloads, the need to devise alternative remedies for classes of litigation that do not imperatively require the full article III

treatment is urgent; one of those classes is small tort claims by federal prisoners.''[113] Congress should carefully consider this Note's proposal as one such alternative remedy.

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113. 879 F.2d 1535, 1536 (7th Cir. 1989).

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The Berne Convention and Protection of Works of Architecture: Why the United States Should Create a New Subject Matter Category for Works of Architecture Under Section 102(a) of the Copyright Act of 1976

At some point each of us has marveled at an architectural structure's beauty. Architecture surrounds us, and becomes the landscape of our cities. Architecture is history, "reflect[ing] the philosophical, intellectual currents, hopes, and aspirations of its time."[1] Although we are moved by an architectural structure's beauty, we rarely consider its utilitarian aspects. Yet, in the United States, works of architecture do not receive copyright protection because the law views architecture with regard to its utilitarian aspects, rather than considering architecture for its beauty as a work of art. Works of architecture should be granted copyright protection commensurate with that of other art forms, such as musical works or literary works. Architecture is a work of art equivalent to these other art forms. Moreover, the Berne Convention, of which the United States is a member, protects works of architecture.[2]

This Note explains why architectural works should receive copyright protection afforded by the Berne Convention. Section I gives a brief history of copyright law — from common law to the Copyright Act of 1976, and ends with the United States's adoption of the Berne Convention in March of 1989. Section II discusses the protection afforded architectural plans and architectural works in the United States today. Section III looks at the Berne Convention and its protection of architectural works. Section IV reviews potential legislative solutions to the protection of works of architecture as suggested by the Copyright Office in its report released on June 19, 1989. Finally, this Note recommends that further legislation be enacted in the United States to protect architectural works regardless of whether the architectural work incorporates separable ornamentation or has a utilitarian function. More specifically, this Note recommends that a new subject matter category under section 102(a) of the Copyright Act of 1976[3] be created for works of architecture.

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1. U.S. Copyright Office, The Report of the Register of Copyrights on Works of Architecture 211 (1989) [hereinafter Copyright Office Report].

2. *Id.* at 157. "[P]rotection of architectural works under copyright is fundamentally not about the protection of buildings per se; it is—certainly within many of the states of the Berne Union—about the protection of perceptible personal expression embodied in some, but not all, buildings." *Id.*

3. 17 U.S.C. § 102(a) (1976).

I. An Overview of Copyright Law

Copyright law dates back to the ratification of the United States Constitution. The drafters of the Constitution thought that protection was needed "[t]o promote the Progress of Science and useful Arts . . . [and] [t]o secur[e], for limited times, to authors and inventors, the exclusive right to their respective writings and discoveries."[4] To secure this protection, the drafters included within the Constitution the Copyright Clause, authorizing Congress to enact copyright legislation. "[T]he public benefits from the creative activities of authors."[5]

Congress has enacted copyright legislation three times.[6] The Acts defining copyright law are the Copyright Act of 1909,[7] the Copyright Act of 1976,[8] and the Berne Convention Implementation Act of 1989.[9]

Although amended by the 1976 Act and the Berne Convention Implementation Act, the 1909 Act still governs those causes of action brought before 1978, the date the 1976 Act became effective.[10] Additionally, the 1909 Act still controls certain rights under the 1976 Act.[11]

The Copyright Act of 1976, effective January 1, 1978, was a comprehensive revision of the 1909 Act.[12] Prior to the 1976 Act, works of authorship were protected either by the 1909 Act or state law. Unpublished works were protected by the common law copyright protection of state law, while the 1909 Act protected published works.[13] The con-

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4. U.S. Const. art. I, § 8, cl. 8.

5. 1 M. Nimmer, Nimmer on Copyright § 1.03[A], at 1-32 (1989).

6. 1 M. Nimmer, *supra* note 5, overview, at OV-1.

7. Act of Mar. 4, 1909, ch. 320, 35 Stat. 1075 [hereinafter the 1909 Act]. *See* 4 M. Nimmer, *supra* note 5, app. 6 for the text of this Act.

8. Act of Oct. 19, 1976, Pub. L. No. 94-553, 90 Stat. 2451 [hereinafter the 1976 Act]. *See* 4 M. Nimmer, *supra* note 5, app. 2 for the text of this Act.

9. Act of Oct. 31, 1988, Pub. L. No. 100-568, 102 Stat. 2853, reprinted in 4 M. Nimmer, Nimmer on Copyright, app. 2A (1989).

10. 1 M. Nimmer, *supra* note 5, overview, at OV-1.

11. *Id.* § 2.08[D], at 2-116 to -117. For instance, the 1976 Act codifies the 1909 Act and does not find infringement in the plans of a structure through the unauthorized construction of a substantially similar building. 17 U.S.C. § 113(b) (1976). Section 113[b] states in pertinent part that

> [t]his title does not afford, to the owner of copyright in a work that portrays a useful article as such, any greater or lesser rights with respect to the making, distribution, or display of the useful article so portrayed than those afforded to such works under the law, whether title 17 or the common law or statutes of a state, in effect on December 31, 1977, as held applicable and construed by a court in an action brought under this title.

Id.

12. Kwall, *Copyright and the Moral Right: Is an American Marriage Possible?*, 38 Vand. L. Rev. 1, 1 (1985). *See* 1 M. Nimmer, *supra* note 5, overview, at OV-2; Diamond, *Preemption of State Law*, 25 Bull. Copyright Soc'y 204 (1978).

13. 1 M. Nimmer, *supra* note 5, § 1.01[B], at 1-9.

fusion brought about by the state and federal dichotomy in copyright law prompted Congress to preempt the field of copyright law, ending the dichotomy and providing one federal scheme of protection for works regardless of whether they were published or unpublished.[14]

The sections of the 1976 Act that address federal preemption of state laws are sections 301(a)[15] and (b).[16] Section 301(a) preempts and abolishes any rights under the common law or state statutes that are equivalent to copyright and that extend to works coming within the scope of federal copyright law.[17] Thus, to be preempted by federal law, the rights under state common law must be equivalent to the rights granted under federal law, and the subject matter protected under state common law must be equivalent to the subject matter protected under federal law.[18]

Section 301(b) leaves three areas unaffected by federal preemption.[19] State rights are not preempted when the subject matter of the state right is not found in the 1976 Act,[20] when the cause of action arose under state law before January 1, 1978,[21] or when the state right violated is not equivalent to any rights protected under federal law in the 1976 Act.[22]

A. *The Copyright Act of 1976: What Can Be Copyrighted?*

Section 102 of the 1976 Act provides that copyright protection is only available for "original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced or otherwise communicated from the medium of expression, whether directly or through the use of a machine or device."[23] Section 102 further provides an illustrative list of various types or categories of copyrightable works. The works protected are: "literary works; musical works, including any accompanying words; dramatic works, including any accompanying music; pantomimes and

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14. 1 M. Nimmer, *supra* note 5, § 1.01[A], at 1-7.
15. 17 U.S.C. § 301(a) (1976).
16. *Id.* § 301(b).
17. *Id.* § 301(a). Section 301(a) states in pertinent part that "all [state] rights that are equivalent to . . . the . . . rights . . . of copyright as specified by section 106 . . . and come within the subject matter of copyright as specified by sections 102 and 103 . . . are governed exclusively by [federal law]." *Id. See* 1 M. Nimmer, *supra* note 5, § 1.01[B][1], at 1-10.
18. H.R. Rep. No. 1476, 94th Cong., 2d Sess. 130-31 (1976).
19. 17 U.S.C. § 301(b) (1976).
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.* § 102(a).

choreographic works; pictorial, graphic and sculptural works; motion pictures and other audiovisual works; and sound recordings."[24]

If a work falls within one of the various types or categories of "works of authorship," other criteria must be met before copyright protection may be granted.[25] The work must be original, fixed in a tangible medium, an original expression of an idea, and released in the public domain after January 1, 1978.[26]

The work of authorship must be "original."[27] Although the 1909 Act did not expressly require originality, the courts inferred the requirement,[28] resulting in its codification in the 1976 Act.[29] However, the 1976 Act does not fully define the term "original."[30] This makes it necessary to refer to case law under the 1909 Act to find a definition.[31]

Unlike patent law, which requires novelty in order to grant protection, copyright law requires only originality, a lesser standard than novelty. Consequently, it is more difficult for a copyright owner to prove copyright infringement.[32] To prove infringement, a copyright holder must show substantial similarity and copying, although the patent holder need only prove substantial similarity. More specifically, the copyright holder must show that the alleged infringer had the opportunity to view the copyright owner's work and that there is a substantial similarity between the copyright owner's work and the infringer's work.[33]

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24. *Id.* The subject matter of the first copyright act enacted in 1790 included maps and charts. Act of May 31, 1790, ch. 15, 1 Stat. 124. In 1802, an amendment added prints to this list of protectible subject matter. Act of Apr. 29, 1802, ch. 36, 2 Stat. 171. In 1870, another amendment added models or designs intended to be perfected as works of the fine arts. Act of July 8, 1870, ch. 230, 86, 16 Stat. 198, 212. The 1870 amendment also extended to copyright owners the exclusive right to "complete, copy execute, finish, and vend the work." *Id.* The 1909 Act broadened the scope of the 1870 amendment by substituting "works of art" for "fine arts." Act of Mar. 4, 1909, ch. 301, 35 Stat. 1075. The subject matter protected under the 1909 Act was included in §§ 5(g) and 5(i) of the Act. *Id.* Section 5(g) protected "works of art, models, or designs for work of art," and § 5(1) protected "drawings or plastic works of a scientific or technical character." *Id.*

25. 17 U.S.C. § 102(a) (1976).

26. *Id.*

27. *Id. See* 1 M. Nimmer, *supra* note 5, § 2.01, at 2-6.

28. *See, e.g.*, Puddu v. Buonamici Statuary, Inc., 450 F.2d 401 (2d Cir. 1971); DuPuy v. Post Tel. Co., 210 F. 883 (3d Cir. 1914); Edward Thompson Co. v. American Law Book Co., 122 F. 922 (2d Cir. 1903).

29. 1 M. Nimmer, *supra* note 5, § 2.01[A], at 2-6.

30. *Id.*

31. E. Mishan & Sons, Inc. v. Marycana, Inc., 662 F. Supp. 1339, 1340-43 (S.D.N.Y. 1987). *See* 1 M. Nimmer, *supra* note 5, § 2.01[A], at 2-7.

32. 1 M. Nimmer, *supra* note 5, § 2.01[A], at 2-10.

33. Arnstein v. Porter, 154 F.2d 464 (2d Cir. 1946); DeAcosta v. Brown, 146 F.2d 408 (2d Cir. 1944); Smith v. Little, Brown & Co., 245 F. Supp. 451 (S.D.N.Y. 1965),

The second element necessary for copyright protection is that the work of authorship be "fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device."[34] This requirement, which originates in the Constitution, requires a work to be fixed in tangible form before it is granted copyright protection.[35] The fixation requirement is satisfied if the work is directly perceivable or if it is perceivable with the aid of a machine.[36] However, the work must be fixed in a tangible form "sufficiently permanent or stable to permit it to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration."[37] For example, a live broadcast on television of an athletic event, which itself is not considered a writing, fails to satisfy this requirement unless the broadcast was simultaneously recorded at the time of the live transmission.[38]

Copyright protection only extends to the expression of the work of authorship. It does not cover the idea itself.[39] The landmark Supreme Court decision of *Baker v. Selden*[40] reiterates this requirement.

In *Baker*, the plaintiff brought a copyright infringement action against the defendant, alleging that the defendant's book copied the methods of accounting found in the plaintiff's book.[41] The plaintiff also alleged that forms contained in the defendant's book were very similar to forms

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aff'd, 360 F.2d 928 (2d Cir. 1966). Because it is very difficult to prove by direct evidence the act of copying, plaintiff can prove copying by defendant's access to the plaintiff's work. 3 M. Nimmer, *supra* note 5, § 13.01[B], at 13-7 to -8. But, if there is no evidence of actual viewing, evidence that defendant had the opportunity to view plaintiff's work will be sufficient. *Id.* If access and substantial similarity are proven, the jury still may find no copying when they believe defendant's work is an independent creation unless the evidence of copying is so strong to prevent such a finding. *Id. See* Novelty Textile Mills, Inc. v. Joann Fabrics Corp., 558 F.2d 1090 (2d Cir. 1977).

34. 17 U.S.C. § 102(a) (1976).

35. 1 M. Nimmer, *supra* note 5, § 2.03[B], at 2-28.1. The Constitution expressly provides that a work must be regarded as a writing. U.S. Const., art. I, § 8, cl. 8.

36. 17 U.S.C. § 102(a) (1976).

37. *Id.* § 101.

38. 1 M. Nimmer, *supra* note 5, § 1.08[C], at 1-50 to -51. However, if the live broadcast is of a writing, such as a play, copyright will be extended to the play, but not to the broadcast. *Id.* Conversely, if the broadcast is not live and is considered a writing, a motion picture for instance, and that which is being filmed is not a writing, an athletic event, the copyright will be extended to the motion picture, but not to the athletic event. Copyright will lie in the manner of filming the athletic event, but not in the event itself. *Id.*

39. 17 U.S.C. § 102(b) (1976). *See also* Mazer v. Stein, 347 U.S. 201 (1954).

40. 101 U.S. 99 (1879).

41. *Id.* at 100.

found in plaintiff's book.[42] The Supreme Court held that defendant's work had not infringed plaintiff's because there was no substantial similarity between the two books.[43] The court stated that although the end results of the two accounting methods were the same, the means used to achieve this end were not substantially similar.[44]

Having found no substantial similarity and thus no copyright infringement, the Court could have ended its opinion.[45] However, the Court further explained in dicta that copyright protection extends only to the expression of an idea, not the idea itself.[46] The defendant had not copied plaintiff's expression of an idea, but only used plaintiff's idea of a book containing an accounting method with worksheets.[47] In short, there was no infringement because the copyright protected only the expression of an accounting method or system, not the accounting method or system itself. Had defendant's book contained the expression of the accounting methods found in plaintiff's book, then plaintiff would have succeeded.

The last element necessary for copyright protection is that the work entered the public domain after January 1, 1978.[48] The Copyright Act of 1976 only extends copyright protection to "works of authorship" issued into the public domain after January 1, 1978.[49] Those works issued in the public domain prior to January 1, 1978, are covered either by the 1909 Act or by applicable state law.[50]

B. The Berne Convention: How Will It Change the Copyright Act of 1976?

On October 31, 1988, President Reagan signed into law the Berne Convention Implementation Act of 1988.[51] This law became effective March 1, 1989, the date the United States became a member of the

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42. *Id.*
43. *Id.*
44. *Id.* at 101.
45. Copyright Office Report, *supra* note 1, at 200.
46. *Baker*, 101 U.S. at 102-03.
47. *Id.*
48. 17 U.S.C. § 301(b) (1976).
49. *Id.* The 1909 Act required that a work be original and fixed in tangible form. The 1976 Act, however, added the requirements that copyright only protects an expression of an idea in a work, and those works released in the public domain after Jan. 1, 1978. *Id.*
50. 1 M. Nimmer, *supra* note 5, § 1.01[B][3], at 1-28. "[S]tate causes of action, like federal causes of action, arising before the effective date of the current Copyright Act, are preserved." *Id.*
51. Berne Convention Implementation Act, *supra* note 9 [hereinafter BCIA]. *See* Copyright Office Report, *supra* note 1, at 140.

Convention for the Protection of Literary and Artistic Works,[52] signed in Berne, Switzerland, on September 9, 1886.[53]

The Berne Convention is a multilateral treaty for international copyright protection.[54] The "cornerstones"[55] of the Berne Convention are that each member nation must accord a foreign work the same copyright protection as it grants domestic works,[56] and each member nation must accord a foreign work a minimum level of protection regardless of what it grants its own nationals.[57] The Berne Treaty[58] has been amended approximately every twenty years since the initial signing of the Treaty.[59] The most current text of the Treaty is the Paris Act of July 24, 1971.[60]

At the initial signing in 1886, ten nations belonged to the Berne Convention.[61] Today, seventy-nine nations belong to the Berne Union.[62] Thus, by becoming a member of the Berne Convention, the United States has truly become "a full-fledged participant in the international copyright community."[63]

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52. Berne Convention (Paris text), July 24, 1971, *reprinted in* 4 M. NIMMER, NIMMER ON COPYRIGHT app. 27 (1989).

53. 3 M. NIMMER, *supra* note 5, § 17.01[B], at 17-6.

54. Smith, *Should the Motion Picture Industry Support or Oppose U.S. Adherence to the Berne Convention?*, 6 ENT. & SPORTS L. 1, 10 (1987).

55. *Id.* at 10.

56. *Id.*

57. *Id.*

58. Hereinafter Berne Treaty or Treaty.

59. International Union for the Protection of Literary and Artistic Works, signed at Berne, Sept. 9, 1886; Additional Act and Declaration signed at Paris, May 4, 1896; revised at Berlin, Nov. 13, 1908; additional protocol signed at Berne, Mar. 20, 1914; revised at Rome, June 2, 1928; revised at Brussels, June 26, 1948; revised at Stockholm, July 14, 1967 (but not ratified by a sufficient number of member states to bring the Stockholm Act into force); revised at Paris, July 24, 1971 (effectively finalizing most of the Stockholm Act). 3 M. NIMMER, *supra* note 5, § 17.01[B], at 17-6 n.12.

60. 3 M. NIMMER, *supra* note 5, § 17.01[B], at 17-6.

61. 3 M. NIMMER, *supra* note 5, § 17.01[B], at 17-6 n.10. "The initial signatories were Germany, Belgium, Spain, France, the United Kingdom, Haiti, Italy, Switzerland, Tunisia, and Liberia. Of those ten signatories, only Liberia failed to ratify the Convention." *Id.*

62. Strauss, *Don't Be Burned By Berne: A Guide to the Changes in the Copyright Laws as a Result of the Berne Convention Implementation Act of 1988*, 71 J. PAT. & TRADEMARK OFF. SOC'Y 374, 374 (1989). All of the major countries of the world belong to the Berne Convention with the exception of the Soviet Union and the People's Republic of China. 3 M. NIMMER, *supra* note 5, § 17.01[B], at 17-6. "[China] is expected to enact its first comprehensive copyright statute in the next several years." *Id.* at n.15. *See also* Baumgarten, *Copyright Relations Between the United States and the People's Republic of China*, 27 BULL. COPYRIGHT SOC'Y 419 (1980).

63. 1 M. NIMMER, *supra* note 5, Highlights of the Berne Convention Implementation Act of 1988, at Comm-1.

Before ratifying the Berne Treaty, Congress stated that the Berne Treaty was not self-executing[64] and would only become the "Supreme Law of the Land" insofar as Congress had expressly legislated.[65] Congress did not want the Berne Treaty, by virtue of the supremacy clause, to become the supreme law of the land.[66] Rather, it wanted the Berne Treaty to be executory, not self-executing. By remaining executory, Congress could implement its own legislation and take a minimalist approach by adopting only those provisions of the Treaty absolutely necessary to join the Berne Convention.[67] The resulting legislation was the Berne Convention Implementation Act of 1988, which, according to Congress, brought United States copyright law into conformity with the standards of the Berne Convention.[68]

The reason for Congress's minimalist approach was that some of the Berne provisions recognized rights not recognized in the United States.[69] For instance, the Berne Convention acknowledges the moral rights doctrine. This doctrine gives an artist the "right to claim authorship of [his] work and to object to any distortion, mutilation or other modification of [his] work, which would be prejudicial to his honor or reputation."[70] This proposition is contrary to United States law which only recognizes an artist's pecuniary interest.[71] Thus, Congress saw the Berne Implementation Act of 1988 as the best way for the United States to join the Berne Union without incorporating those provisions of the Berne Treaty not recognized by United States law.

The central tenet of the Berne Treaty is its prohibition of formalities.[72] The treaty's antipathy for formalities stands in direct contradiction to the United States's affinity for formalities as a condition to copyright

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64. BCIA, *supra* note 9, at 2(1).

65. *Id.* at 2(2).

66. U.S. Const., art. VI, cl. 2. The supremacy clause states that "[t]his Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land." *Id.*

67. Note, *Internationalizing the Copyright Code: An Analysis of Legislative Proposals Seeking Adherence to the Berne Convention*, 76 Geo. L.J. 467, 481 (1987). *See* 1 M. Nimmer, *supra* note 5, Highlights of the Berne Convention Implementation Act of 1988, at Comm-14.

68. BCIA, *supra* note 9. The BCIA has 13 provisions, and one-third of these provisions state in one way or the other that the Berne Convention is not self-executing. 1 M. Nimmer, *supra* note 5, § 1.12[A], at 1-100.

69. 1 M. Nimmer, *supra* note 5, § 1.12[A], at 1-100 to -101.

70. Berne Convention (Paris text), *supra* note 52, art. 6*bis*, at 27-5 to -6.

71. Kwall, *supra* note 12, at 2.

72. 134 Cong. Rec. H3082 (daily ed. May 10, 1988) (statement of Rep. Kastenmeier).

protection.[73] Notice is one formality required in the past from both American claimants and foreign claimants seeking copyright protection in the United States.[74] Failure to include a copyright notice on the article sought to be protected resulted in loss of copyright protection.[75] Notice was even required of the foreign claimant despite the fact that the foreign claimant's own country did not require this formality.[76]

The Berne Treaty does away with formalities as a condition for copyright protection, stating that "the enjoyment and the exercise of [copyright] shall not be subject to any formality" in "countries of the Union other than the country of origin."[77] The Berne Treaty prevents the United States from placing formalities on foreigners as a condition for copyright protection in the United States. However, it does not prevent the United States from requiring formalities from its own nationals[78] because the Berne Treaty only purports to govern the scope of formalities required by a country of a foreigner; it does not purport to govern the scope of formalities required by a country of its own citizens.[79] For example, the United States can discriminate against its own citizens and require the formality of notice as a condition to copyright protection, but it cannot require the same formality from foreigners as a condition to copyright protection in the United States.[80]

The Berne Treaty does, however, permit countries to require formalities as a condition to obtaining certain remedies, licenses, or exemptions, and these formalities apply to both nationals and foreigners.[81] The United States, for instance, could require the copyright formality of notice from both its own nationals and foreigners as a condition to recovering certain remedies, such as payment of attorney fees or obtaining statutory damages.[82]

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73. Strauss, *supra* note 62, at 379. *See* 3 M. Nimmer, *supra* note 5, § 17.01[B], at 17-7.

74. 1 M. Nimmer, *supra* note 5, § 17.01[B], at 17-7.

75. 1 M. Nimmer, *supra* note 5, at Comm-21.

76. 3 M. Nimmer, *supra* note 5, § 17.01[C][2][b], at 17-17.

77. Berne Convention (Paris text), *supra* note 52, art. 5(1), at 27-4.

78. 3 M. Nimmer, *supra* note 5, § 17.01[B][1], at 17-9.

79. *Id.*

80. *Id.*

81. *Id.* Congress has chosen to keep those sections of the Copyright Act requiring notice not as a condition for copyright protection but as a "useful tool for securing procedural advantages to copyright proprietors." *Id.* That is, notice will no longer be a condition for copyright protection for either the American or the foreigner, but it will be a condition necessary for the recovery of certain damages, such as attorney fees. 1 M. Nimmer, *supra* note 5, at Comm-21.

82. *Id.*

II. United States Protection of "Works of Architecture"

A. Copyright Protection for Architectural Plans

Currently, architectural plans and drawings are protected by copyright law.[83] However, the extent and scope of the protection granted to architectural plans and drawings have been widely debated. It is undisputed that "copyright in architectural plans protects against the 'copying' of such plans by another,"[84] and commentators agree that the "making of two-dimensional plans through direct copying of other two-dimensional plans" constitutes copying.[85] However, it is disputed whether the act of using the original plans without authorization to build a substantially similar building constitutes copying.[86]

The court in *Imperial Homes v. Lamont*[87] concluded that constructing a substantially similar building is permissible so long as the imitator does not copy the actual blueprints themselves.[88] However, the court did not determine whether using the actual blueprints of the original building, without duplicating them, to build a substantially similar building constitutes copying.

Thus, the question remains whether copyright in architectural plans protects against the unauthorized use of those plans to build the structure depicted therein. The decisions are varied, and for the most part have relied on *Baker v. Selden*,[89] in which the Supreme Court held that copyright protects only the expression of an idea, not the art, idea, or system explained in the work.[90] However, some courts also have interpreted *Baker* as standing for the proposition that the copying of architectural plans is permissible when the copying is necessary for use rather than for explanation.[91] Essentially, these courts have drawn a distinction between copying for use (acquiring, without authorization, plans to build the depicted structure),[92] and copying for explanation

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83. H.R. Rep. No. 1476, 94th Cong., 2d Sess. 55 (1976). The House Report states that "[a]n architect's plans and drawings would, of course, be protected by copyright . . . ." *Id. See also* Aitken v. Empire Constr. Co., 542 F. Supp. 252 (D. Neb. 1982); Schuchart & Assocs. v. Solo Serve Corp., 540 F. Supp. 928 (W.D. Tex. 1982).

84. Note, *Standing on Shaky Ground: Copyright Protection for Works of Architecture*, 6 Art & L. 70, 72 (1981). *See* 1 M. Nimmer, *supra* note 5, § 2.08[D], at 2-115.

85. Note, *supra* note 84, at 72.

86. *Id.*

87. 458 F.2d 895 (5th Cir. 1972).

88. *Id.* at 899.

89. 101 U.S. 99 (1879).

90. *Id.* at 101.

91. Shipley, *Copyright Protection For Architectural Works*, 37 S.C.L. Rev. 393, 406-07 (1986).

92. 1 M. Nimmer, *supra* note 5, § 2.08[D], at 2-118.

(copying, without authorization, plans to explain to a builder how to construct a substantially similar building).[93] Courts prohibit copying for explanation, and disagree whether copying for use should be prohibited.[94]

An architect's plans may be used in two different situations.[95] First, plans may be copied or adapted by a draftsman and used to build a substantially similar structure. Secondly, plans simply may be used directly, without copying, to build a substantially similar building. Early cases held that the unauthorized use of plans in either situation did not constitute copyright infringement.[96] Some decisions following these early cases held that copyright law protects the unauthorized use of plans when the defendant had copied the plans first and then used the plans to construct a substantially similar building.[97]

Thus, the courts have expressly protected a copyright holder from unauthorized copying of plans and the subsequent use of those plans to build a substantially similar building, but they have not protected the holder when the plans were used to build a substantially similar structure, but were never actually copied.[98]

Courts following a broad interpretation of *Baker* rationalize that protecting the architect from the unauthorized use of his plans when they have not been copied gives an architect too much control over the use of his plans.[99] In *Muller v. Triborough Bridge Authority*[100] and *DeSilva Construction Corporation v. Herald*,[101] both courts refused to find infringement when there was unauthorized use of the plans unless it could be proven that the plans had actually been duplicated. In *Muller*, the court held that the defendant could use the plaintiff's copyrighted drawing in designing and constructing the bridge approach because the plaintiff's copyright failed to prevent anyone from using the idea set forth in the plaintiff's plans.[102] Similarly, the court in *DeSilva* held that the prohibited act was the unauthorized copying of the plans, not the unauthorized use of the plans.[103]

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93. *Id.*

94. Shipley, *supra* note 91, at 408-09.

95. 1 M. Nimmer, *supra* note 5, § 2.08[D][2], at 2-106.

96. DeSilva Constr. Corp. v. Herald, 213 F. Supp. 184, 195 (M.D. Fla. 1962); Muller v. Triborough Bridge Auth., 43 F. Supp. 298, 300 (S.D.N.Y. 1942).

97. Donald Frederick Evans & Assoc. v. Continental Homes, Inc., 785 F.2d 897 (11th Cir. 1986); Herman Frankel Org. v. Wolfe, 184 U.S.P.Q. (BNA) 813 (E.D. Mich. 1974); Herman Frankel Org. v. Tegman, 367 F. Supp. 1051 (E.D. Mich. 1973).

98. Shipley, *supra* note 91, at 403.

99. *See, e.g.*, Schuchart & Assocs. v. Solo Serve Corp., 540 F. Supp. 928, 941 (W.D. Tex. 1982).

100. 43 F. Supp. 298 (S.D.N.Y. 1942).

101. 213 F. Supp. 184 (M.D. Fla. 1962).

102. 43 F. Supp. at 300.

103. 213 F. Supp. at 195-96.

A more narrow reading of *Baker* may be found in *Herman Frankel Organization v. Tegman*.[104] The court in this case recognized that copying for use is as harmful as copying for explanation. The court ruled that an architect should be able to prohibit others from copying copyrighted house plans and then using the copied plans to build the house depicted.[105] But the court stated this does not mean that the architect can preclude others from using the ideas taught by the plans to build another similar house.[106] This court seemed to declare the basic principle that, although copyright law protects the architect from another person building a house based on copied plans, it does not protect the ideas disclosed in those plans.[107]

In *Donald Frederick Evans & Associates v. Continental Homes, Inc.*,[108] the Court of Appeals for the Eleventh Circuit similarly stated that a defendant who copies floor plans set forth in a promotional booklet and then uses the copies to build the structure depicted in the plans is liable for copyright infringement.[109]

One may distill from this line of cases that all courts agree that copyright infringement in the plans of a structure occurs when the plans themselves are copied for explanation (that is, for purposes of explaining to a builder how to construct a substantially similar building). Additionally, the courts have held that copyright infringement occurs when the plans are copied and then used without authorization to build a substantially similar structure.

However, the courts do not agree that copyright infringement also occurs when the plans, although not copied, are used without authorization to build the structure depicted therein. An architect should be protected in this instance because the interest divested here is the same as the interest divested when the plans are copied and then used to build a substantially similar building.[110] Admittedly, this situation would be rare because it would be almost impossible for someone to acquire copyrighted plans and use them without copying them, especially considering the number of contractors and subcontractors needed to build a structure. Nonetheless, it is possible, and the architect's interest should be protected.

Despite the similarity between the two situations, many commentators have argued that the situation in which the plans are used without

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104. 367 F. Supp. 1051 (E.D. Mich. 1973).
105. *Id.* at 1053.
106. *Id.*
107. *Id.* *See* Shipley, *supra* note 91, at 411 n.88.
108. 785 F.2d 897 (11th Cir. 1986).
109. *Id.* at 904-05
110. *Id.*

copying does not constitute infringement.[111] First, they state that no infringement occurs because a structure is not a "copy" of the plans. That is, a structure built from the unauthorized use of the plans is a result of the plans, not a copy of the plans, and is not the equivalent of an actual duplication into another set of plans.[112] Second, they contend no infringement occurs when the architect's plans are used without his consent because copyright does not include the right of an architect to control the use of his plans.[113]

Neither of these reasons for denying copyright protection is adequate. Copying can occur in any medium.[114] The mere fact that the medium in this situation is a three-dimensional structure rather than two-dimensional plans is irrelevant,[115] because "one possible method of 'fixing' a plan in 'tangible form' from which the work can be perceived would be to build the building described by the plans."[116] Additionally, giving an architect the right of control over the unauthorized use of his plans would still leave the well-established doctrine of *Baker* intact.[117]

Baker should be interpreted as standing for the proposition that an architect simply has no exclusive right to ideas, methods of construction, or processes of work depicted in his plans. It should not be interpreted as holding that an architect has no control over the unauthorized use of his plans.[118] Liability should not turn on whether the copying was done for use or for explanation, as both instances equally divest the architect of ideas and economic and creative interest in his work.[119] Melville Nimmer was correct in saying that

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111. *Id. See, e.g.*, Schuchart & Assocs. v. Solo Serve Corp., 540 F. Supp. 928, 941 (W.D. Tex. 1982); DeSilva Constr. Corp. v. Herald, 213 F. Supp. 184, 195 (M.D. Fla. 1962); Muller v. Triborough Bridge Auth., 43 F. Supp. 298, 300 (S.D.N.Y. 1942).

112. *DeSilva Constr. Corp.*, 213 F. Supp. at 196. "The court also found that buildings were not 'copies' of the plans and could not 'publish' them." Copyright Office Report, *supra* note 1, at 37 n.39.

113. *DeSilva Constr. Corp.*, 213 F. Supp. at 195. The court stated that "it appears to be the unanimous view of respected text writers that, under the current copyright laws of the United States, the architect does not have the exclusive right to build structures embodied in his technical writings." *Id. See also* Imperial Homes v. Lamont, 458 F.2d 895, 899 (5th Cir. 1972) (where the court stated that copyrighted drawings do not "clothe their author with the exclusive right to reproduce the dwelling pictured"); Schuchart & Assocs. v. Solo Serve Corp., 540 F. Supp. 928, 941 (W.D. Tex. 1982); Muller v. Triborough Bridge Auth., 43 F. Supp. 298, 300 (S.D.N.Y. 1942).

114. 1 M. Nimmer, *supra* note 5, § 2.08[D], at 2-119 n.176.; 2 M. Nimmer, *supra* note 5, § 8.01[B].

115. 2 M. Nimmer, *supra* note 5, § 8.01 [B], at 8-15. *See also* Shipley, *supra* note 91, at 415-16.

116. Hellmuth, *Obsolescence Ab Initio: The New Act and Architectural Copyright*, 22 Bull. Copyright Soc'y 169, 178 (1975).

117. Shipley, *supra* note 91, at 414.

118. *Id.* at 413.

119. *Id.* at 414.

> [t]he copyright in plans should very definitely protect against the unauthorized use of such plans in the building of a structure. A copyright in architectural plans which does not include the exclusive right to erect structures based upon such plans makes no more sense than copyright in musical or dramatic compositions without the exclusive right of public performance. In order to be meaningful the copyright must include rights which give the work economic value.[120]

In summary, an architect should be able to control the use of his plans because the architect is not seeking to protect ideas as they appear individually in the plans, but is seeking to protect his economic interest in the compilation of ideas which, when depicted in the plans, form the architect's own original expression.

An architect should also be protected from attempts to build a substantially similar structure from either photographs of the original building or measured drawings of the original building.[121] However, the courts are hesitant to provide protection in this instance because they view it as equivalent to providing protection to the original structure itself.[122]

In response to this rationale, the Frank Lloyd Wright Foundation has stated that "the legal system [provides] an anomalous result which everyone senses is wrong, but for which an equitable solution is believed to be particularly elusive."[123] Simply put, an architect's interests are no less divested when a substantially similar building is built based on measured drawings or a photograph than when the building is built from the unauthorized use of copied plans or the unauthorized use of uncopied plans.[124]

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120. M. Nimmer, *Comments and Views Submitted To the Copyright Office on Copyright in Architectural Works*, Copyright L. Revision 85 (1959).

121. G. Quatman & M. Brown, Response to Copyright Office Notice of Inquiry on Architectural Work Protections (Sept. 16, 1988), *reprinted in* Copyright Office Report, *supra* note 1, app. C, comment 5, at 8. The AIA defines measured drawing as a drawing "made by careful observation or surveying of an existing building's exterior and or interior and then creating new graphic works from the observation and surveying." Proskauer Rose Goetz & Mendelsohn on behalf of the American Institute of Architects, Response to Copyright Notice of Inquiry on Architectural Work Protections (Sept. 16, 1988), *reprinted in* Copyright Office Report, *supra* note 1, app. C, comment 6, at 4, n.2 [hereinafter Proskauer].

122. Donald Frederick Evans & Assoc. v. Continental Homes, Inc., 785 F.2d 897, 901 n.7 (11th Cir. 1986). *See* Proskauer, *supra* note 121, at 6.

123. Frank Lloyd Wright Found., Response to Copyright Office Notice of Inquiry on Architectural Work Protections, *reprinted in* Copyright Office Report, *supra* note 1, app. C, comments of the Frank Lloyd Wright Found., at 9.

124. *Id.*

However, because the law does not protect the architect when measured drawings are used to build a substantially similar building because the effect would be to protect the structure itself, the issue arises as to what copyright protection, if any, is afforded to architectural structures.

B. Copyright Protection of Architectural Structures

Architectural structures are protected in only two instances in the United States.[125] They are protected first when the structure is purely nonfunctional or monumental[126] (for example, the Washington Monument), and second, when the functional structure incorporates design features that are conceptually separable from the utilitarian aspect of the structure.[127] Even in this instance, however, only the design feature is protected,[128] not the structure.[129] For example, separable ornamentation such as a gargoyle on the side of a building would be protected, but the building itself would not be protected.[130]

The courts' reluctance to extend copyright protection to works of architecture is based on sections 102(a)(5)[131] and 101[132] of the 1976 Act. Although section 102(a)(5) protects pictorial, graphic, and sculptural works, the definition of these types of works in section 101 raises a barrier to the inclusion of architectural works in this category of protectible subject matter.[133] First, the definition raises a barrier to the

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125. H.R. REP. No. 1476, 94th Cong., 2d Sess. 55 (1976).

126. *Id. See* Jones Bros. Co. v. Underkoffler, 16 F. Supp. 729 (M.D. Pa. 1936).

127. H.R. REP. No. 1476, 94th Cong., 2d Sess. 55 (1976).

128. *Id.*

129. *Id. See also* Donald Frederick Evans & Assoc. v. Continental Homes, Inc., 785 F.2d 897, 901 n.7 (11th Cir. 1986).

130. H.R. REP. No. 1476, 94th Cong., 2d Sess. 55 (1976). *See* COPYRIGHT OFFICE REPORT, *supra* note 1, at 220.

131. 17 U.S.C. § 102(a)(5). This section provides that "[c]opyright protection subsists, in accordance with this title, in original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. Works of authorship include . . . pictorial, graphic, and sculptural works." *Id.*

132. *Id.* § 101. This section states that

> [p]ictorial, graphic, and sculptural works include two-dimensional and three-dimensional works of fine, graphic, and applied art, photographs, prints and art reproductions, maps, globes, charts, technical drawings, diagrams, and models. Such works shall include works of artistic craftsmanship insofar as their form but not their mechanical or utilitarian aspects are concerned; the design of a useful article, as defined in this section, shall be considered a pictorial, graphic, or sculptural work only if, and only to the extent that, such design incorporates pictorial, graphic, or sculptural features that can be identified separately from, and are capable of existing independently of, the utilitarian aspects of the article.

Id.

133. Note, *supra* note 84, at 70.

protection of a functional structure itself because it provides that the mechanical or utilitarian aspects of pictorial, graphic, and sculptural works are not protected.[134] Second, section 101 serves as a barrier to the protection of a functional structure because it provides that a useful article's separate ornamentation or embellishments will be considered a pictorial, graphic, and sculptural work if the ornamentation is separable from and capable of existing independently of the utilitarian aspects of the useful article.[135]

Taken together, these two provisions would preclude all structures, aside from those structures that are purely monumental, from being protected because most structures have a utilitarian aspect because they provide shelter as a home or a place of business. The scope of protection for useful articles as codified in section 101 originates from *Mazer v. Stein*,[136] in which the Supreme Court held that "[i]ndependent works of art may be copyrighted even if they are incorporated into useful articles, but that protection in such cases . . . extend[s] only to that aspect of the article . . . [that is] independent of the useful article."[137] This requirement is referred to today as conceptual separability.

Conceptual separability is the key criterion that a useful article must meet if any aspects of that article are to be protected.[138] The House Report accompanying the 1976 Act states the intention that the overall design of a useful article, although aesthetically pleasing, is not copyrightable subject matter. The Report states that only those elements that are physically or conceptually identifiable from the utilitarian aspects of the useful article are protected.[139] For example, the House Report explains

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134. 17 U.S.C. § 101. The pertinent part of the section provides that "[pictorial, graphic, and sculptural works] shall include works of artistic craftsmanship insofar as their form but not their mechanical or utilitarian aspects are concerned." *Id.*

135. Note, *supra* note 84, at 70.

> The design of a useful article, as defined in this section, shall be considered a pictorial, graphic, or sculptural work only if, and only to the extent that, such design incorporates pictorial, graphic, or sculptural features that can be identified separately from, and are capable of existing independently of the utilitarian aspects of the article.

17 U.S.C. § 101.

136. 347 U.S. 201 (1954).

137. *Id.*

138. Note, *supra* note 84, at 70.

139. H.R. Rep. No. 1476, 94th Cong., 2d Sess. 55 (1976).

> [A]lthough the shape of an industrial product may be aesthetically satisfying and valuable, the Committee's intention is not to offer it copyright protection under the bill. Unless the shape of . . . an industrial product contains some element that, physically or conceptually can be identified as separable from the utilitarian aspects of that article, the design would not be copyrighted under the bill.

Id.

that a carving on the back of a chair would be protected, but that the overall design of the chair would not.[140] With regard to architectural works, the House Report provides that protectible subject matter includes only the separable ornamentation and not the overall design of the structure.[141] In summary, both section 102(a)(5) and *Mazer v. Stein*, as codified in section 101, provide a rationale for the generally accepted rule that monumental structures are protectable subject matter as are a building's separable ornamentation or embellishments.

Section 102(b)[142] and *Baker v. Selden*[143] also serve as reasons for the courts' reluctance to grant protection to works of architecture.[144] Section 102(b) codifies the *Baker* rule that copyright protection does not extend to an idea, but only to the expression of an idea.[145] Section 102(b) also states that copyright protection does not extend to procedures, processes, systems, and methods of construction.[146] This rule certainly applies to architects and works of architecture, but it should not preclude works of architecture from being protected. Experts also agree that neither *Baker* nor section 102(b) precludes works of architecture from being protected.[147]

The Copyright Office published a Notice of Inquiry in the Federal Register on June 8, 1988,[148] asking interested persons to comment on a number of issues regarding works of architecture and works related to architecture.[149] Responses to the Notice of Inquiry agreed that neither

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140. *Id.*

141. *Id.*

142. 17 U.S.C. § 102(b)(1976). "In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated or embodied in such work." *Id.*

143. 101 U.S. 99 (1879).

144. COPYRIGHT OFFICE REPORT, *supra* note 1, at 200.

145. *Id.*

146. 17 U.S.C. § 102(b).

147. COPYRIGHT OFFICE REPORT, *supra* note 1, at 202. *See* COPYRIGHT OFFICE REPORT, *supra* note 1, app. C, comment 3 at 2, comment 5 at 11-12, comment 6 at 5, comment 11 at 2-3. Professor Nimmer has also written: "It is noteworthy that in *Mazer v. Stein*, 347 U.S. 201 (1954), the Supreme Court interpreted *Baker v. Selden*, 101 U.S. 99 (1879), as merely holding that the copying of an idea without copying the expression of the idea . . . does not constitute infringement." 1 M. NIMMER, *supra* note 5, § 2.18[D].

148. Notice of Inquiry: Works of Architecture, 53 Fed. Reg. 21,536 (June 8, 1989).

149. *Id.* The Inquiry touches on three broad areas: (1) the type of copyright and other forms of protection currently accorded works of architecture and works related to architecture; (2) the need, if any, for protection beyond that now available including whether perceived deficiencies are capable of resolution through private consensual arrangements; and 3) the laws and actual practices of foreign countries in protecting works of architecture and works related to architecture. *Id.*

section 102(b) nor *Baker* prohibits works of architecture from being protected.[150] The Frank Lloyd Wright Foundation stated:

> We do not view *Baker v. Selden* or 102(b) of the Act as having any effect on the protection of copyrightable elements of a building or structure under copyright, just as neither affects protection of any other copyrightable work. The design of a building or structure is not 102(b) subject matter. [We] concur with . . . Professor Nimmer that "the rationale for the doctrine of *Baker v. Selden* in no event justified the denial of copyrightability to any work."[151]

Thus, a proper reading of section 102(b) and *Baker* would provide that an architect cannot claim a copyright in the ideas, processes, and methods of construction of a work of architecture.[152] But an architect should be able to claim a copyright in and protect his own manner of expressing those ideas because those ideas, when taken together, form the architect's original expression as exemplified in a completed structure.[153]

Of the nine responses received by the copyright office, seven favored protection for architectural works.[154] The commentators noted that protection in other areas of the law is inadequate.[155] These areas include design patents, trademark, contract, misappropriation, conversion, unfair competition, and unjust enrichment.[156]

Design patents protect the ornamental appearance of a new, original, and nonobvious design.[157] This form of protection is inadequate because,

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150. Copyright Office Report, *supra* note 1, at 202. "The Notice of Inquiry asked for comment on the effect, if any, of *Baker v. Selden* on protection of works of architecture. Four commentators responded to this question. All agreed that *Baker v. Selden* in no way restricted protection for these works as a class." *Id.* The five commentators who responded to this question are: Professor David E. Shipley, University of South Carolina; the American Institute of Architects; the Frank Lloyd Wright Foundation; G. William Quatman, Esq., AIA, and Mark E. Brown, an attorney with a degree in architecture. *Id.* The other commentators include Frank X. Arvan, an architect; Michael E. Minns, an attorney; Mark G. Gilligan, a structural engineer; Thompson, Hine & Flory, a law firm representing architects, contractors, and owners; IBM; and David K. Perdue, on behalf of the American Institute of Architects as Associate General Counsel. *Id.* at app. C.

151. Frank Lloyd Wright Found., *supra* note 123, at 3.

152. Shipley, *supra* note 91, at 412.

153. *Id.* at 417.

154. Copyright Office Report, *supra* note 1, at 195.

155. *Id.* at 63-69.

156. *Id.*

157. 35 U.S.C. § 171 (1952).

first, the term of protection granted for a design patent, 14 years,[158] is much shorter than the term of protection granted for copyright, which extends for the life of the author and for an additional 50 years after the author's death.[159] Secondly, the requirements of novelty, originality, and nonobviousness required by design patent law present a formidable hurdle that would deny protection to most, if not all, works of architecture.[160] Lastly, although design patents have protected the architectural components of some architectural works, the cases granting such protection[161] are old and rarely followed.[162]

Trademark law has offered limited protection to the unique design of commercial businesses.[163] But this protection extends to the owner of the commercial business, not to the architect, because the public associates the unique design of the structure with the owner's product or services rather than with those of the architect.[164] Thus, it is evident that trademark law does not adequately protect the architect. The commentators further noted that contract protection is often inadequate because the plans are usually revealed prior to the contract, and because a contract does not offer the architect much protection against third parties who duplicate a structure that is constructed pursuant to a contract.[165]

Finally, recovery under causes of action for misappropriation, conversion, unfair competition, or unjust enrichment appears equally unlikely, because allowing recovery may create a conflict with the principle of federal preemption embodied in section 301 of the 1976 Act.[166] Section 301 provides that the 1976 Act preempts any state causes of action that grant legal or equitable rights that are the equivalent of or come within the general scope of copyright, in works that come within the subject matter of copyright.[167] The Copyright Office noted that it is not the application of a state cause of action such as conversion or misappropriation to a claim that renders the claim preempted; rather, it is the nature of the claim pleaded by the plaintiff and the elements needed to prove that claim which determine whether federal law preempts.[168] A general rule is that if the activity pleaded amounts to a claim of copyright

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158. *Id.*
159. 17 U.S.C. § 301(a)(1976).
160. Frank Lloyd Wright Found, *supra* note 123, at 14-15.
161. Ritter - Conley Mfg. Co. v. Aiken, 203 F. Supp. 669 (3d Cir. 1913).
162. G. Quatman & M. Brown, *supra* note 121, at 7.
163. *See, e.g.*, Fotomat Corp. v. Cochran, 437 F. Supp. 1231 (D. Kan. 1977).
164. G. Quatman & M. Brown, *supra* note 121, at 7.
165. *Id.* at 8.
166. 17 U.S.C. § 301(a) (1976).
167. *Id.*
168. Copyright Office Report, *supra* note 1, at 68.

infringement, federal law preempts the state action pleaded.[169] Thus, although some state actions will survive federal law preemption, others will not because they do not differ qualitatively from copyright infringement.[170] It is for this reason alone that other forms of protection for works of architecture are needed.

The reasons given for granting protection to works of architecture include that protection would encourage creativity benefiting both the architect and the public.[171] That is, the public would benefit from the dissemination of unexecuted plans, as architects would be able to publicize plans without the fear that others will use the plans to construct the depicted structure.[172] The commentators also noted that architecture is a traditional fine art that should be granted the protection other art forms enjoy, especially because the Berne Convention, of which the United States is a member, protects works of architecture.[173]

The 1976 Act, however, only grants limited protection to works of architecture.[174] As mentioned earlier, only the separable ornamentation or artistic sculpture added to the functional structure is protected.[175]

The test of whether a functional structure's design features can be identified separate from, and can exist independent of, the utilitarian aspects of the functional structure is referred to as the conceptual separability test.[176] However, there is disagreement concerning the appropriate standard for conceptual separability and what should be protected under the test.[177]

C. *The Evolution of Conceptual Separability*

According to the Copyright Office, conceptual separability requires that the design features, although physically inseparable from the useful article, clearly be recognizable from the useful article in order that they may be protected.[178] The design features and the "useful article [must

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169. *Id.*

170. *Id.*

171. *Id.* at 198.

172. *Id.*

173. *Id.*

174. *See* 17 U.S.C. § 102(a)(5) (1976); *id.* § 101.

175. *See supra* text accompanying notes 124-29.

176. Copyright Office Report, *supra* note 1, at 204. *See supra* text accompanying notes 137-40.

177. *E.g.*, Brandir Int'l, Inc. v. Cascade Pac. Lumber Co., 5 U.S.P.Q. 2d (BNA) 1089 (2d Cir. 1987); Carol Barnhart, Inc. v. Economy Cover Corp., 773 F.2d 411 (2d Cir. 1985); Kieselstein-Cord v. Accessories by Pearl, Inc., 632 F.2d 989 (2d Cir. 1980); Esquire Inc. v. Ringer, 591 F.2d 796 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 908 (1979).

178. Copyright Office, Copendium II Copyright Office Practices, para. 505.03 (1984).

be able to] exist side by side and be perceived as fully realized, separate works — one an artistic work, and the other a useful article."[179]

This test suggested by the Copyright Office is overbroad because it ultimately denies protection to many works that should be given copyright protection. It would not, for instance, prevent someone from copying the attractiveness of a building's overall shape. Under this test, an architect is protected only if an imitator uses or copies a structure's separable ornamentation and embellishments, incorporating them into a second structure. This test also discriminates in favor of styles of architecture that incorporate separable ornamentation. The separable ornamentation representative of the Victorian style would be protected, although the sleek and simple lines of the Miesian style would not be protected.[180] Lastly and perhaps most importantly, this test fails to recognize that a work of architecture is as much a work of art as subject matter, such as literature or music, currently protected by section 102(a) of the 1976 Act.

Many jurists have applied different tests for conceptual separability other than the one suggested by the Copyright Office. One such test is the temporal displacement test.[181] Under this test, conceptual separability exists "whenever the design creates in the mind of the ordinary observer two different concepts that are not inevitably entertained simultaneously."[182] Conceptual separability exists when the beholder temporarily displaces the utilitarian functions of the article and instead recognizes the design features of the article.[183]

In *Carol Barnhart, Inc. v. Economy Cover Corp.*,[184] Judge Newman dissented and applied the temporal displacement test to an artistically designed chair, stating that the requisite separateness exists if the ordinary beholder can temporarily displace the utilitarian function of the chair and entertain separably the artistic aspects of the chair.[185] Separateness would not exist if the ordinary beholder recognized the artistic aspects of the chair simultaneously with the utilitarian aspects of the chair.[186] According to Judge Newman, the issue of conceptual separability should be determined by the jury.[187] Additionally, he stated that when deter-

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179. *Id.*

180. Shipley, *supra* note 91, at 427.

181. Carol Barnhart, Inc. v. Economy Cover Corp., 773 F.2d 411, 422 (2d Cir. 1985).

182. *Id.* That is, the "article must stimulate in the mind of the beholder a concept that is separate from the concept evoked by its utilitarian function." *Id.*

183. *Id.*

184. 773 F.2d 411 (2d Cir. 1985).

185. *Id.* at 423 (Newman, J., dissenting).

186. *Id.*

187. *Id.*

mining whether the two concepts are entertained simultaneously or separately, the trier of fact should be able to consider whatever evidence it deems necessary.[188] For instance, factors such as how the item is displayed (as a work of art apart from its utilitarian function), expert opinion, and survey evidence should all be received.[189]

Requiring the jury to determine whether the two concepts, that of a work of art and that of a utilitarian article, are entertained simultaneously is a tedious task that inevitably would lead to incongruous results. Moreover, the requirement of this test, whether two concepts are entertained simultaneously, is a fiction that should not govern the granting or denial of copyright protection to a work of architecture.

Unlike the test suggested by the Copyright Office, the temporal displacement test arguably may extend protection to the overall shape of a structure when that shape as a work of art is not entertained simultaneously with the structure's utilitarian function. However, this test is inappropriate because it only offers protection to a limited and ephemeral class of architectural structures; that is, those that have demonstrably separable artistic aspects and utilitarian functions.

Another test offered by the Frank Lloyd Wright Foundation suggests that conceptual separability should turn on whether the "ordinary observer understands the work as having a conceptually dual function — that of a work of art and that of a useful article."[190] Of the tests suggested by various jurists, this test seems to be the best; first, because it arguably extends protection to works of architecture under existing law, eliminating the need for further legislation,[191] and second, because the test is already used in trademark law.[192]

In its comments to the Copyright Office, the Frank Lloyd Wright Foundation concluded that existing copyright protection should be applied to cover architectural works.[193]

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188. *Id.*

189. *Id.*

190. Frank Lloyd Wright Found., *supra* note 123, at 23. "Factors which could tend to show functioning as art work would include, without limitation: a materially higher price paid for the work because of the artwork component; any display or attempted display of the work in museums; publicity of the work as a work of art; the awarding of artistic prizes and or the entering of the work in artistic competitions; inclusion in art publications; direct evidence of consumer perception of the work as a work of art (by affidavit or survey evidence); demonstrations of the importance of artistic concerns in creating the plans or drawings, expert testimony; and the number of copies made or intended to be made." *Id.*

191. *Id.* at 20.

192. *Id.* at 22.

193. *Id.* at 20.

> We believe that existing copyright law should be interpreted to cover the pictorial, graphic or sculptural features of a design of an architectural work to the extent such features are understood to "exist independently" of the utilitarian aspects of the useful article. These pictorial, graphic or sculptural features of the design could, under this approach, inhere in the entire architectural work, or in portions of the work.[194]

The dual function test has been applied in trademark law to determine whether a useful article is worthy of trademark protection.[195] If the useful article is perceived as having a nonfunctional trademark purpose in addition to its utilitarian purpose, then conceptual separability exists and trademark protection is granted.[196] For instance, the Court of Custom and Patent Appeals granted trademark protection to a cleaning product container despite the container's utilitarian function because it was shown that the design of the container was understood as a "symbol of origin" (that is, a trademark).[197] The Frank Lloyd Wright Foundation argues that the same test could be applied in copyright law to determine whether a useful article is perceived also as a work of art.[198]

Unlike the temporal displacement test, the dual function test does not require the tedious task of knowing whether the beholder can temporarily displace the utilitarian function of the article.[199] Nor does this test require that the articles exist "side by side and be perceived as fully realized, separate works,"[200] one artistic and the other useful. Perhaps most importantly, this test recognizes that an architectural structure's overall shape is the product of an architect's work and is no less a form of art than other subject matter currently protected by section 102(a) of the 1976 Act. "Just as the arrangement of individually uncopyrightable words results in the production of a copyrightable literary work,"[201] so too should the arrangement of individually uncopyrightable components of architecture result in the production of a copyrightable architectural work.

The Copyright Office has suggested another test for conceptual separability that also arguably supports protection for works of architecture under existing law.[202] Similar to the dual-capacity test suggested

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194. *Id.*
195. *Id.* at 22.
196. *Id.*
197. *Id.*
198. *Id.*
199. Copyright Office Report, *supra* note 1, at 208.
200. *Id.*
201. Proskauer, *supra* note 121, at 5.
202. Copyright Office Report, *supra* note 1, at 208-10. This test was suggested in the Copyright Office Report released June 19, 1989. *See supra* note 1.

by the Frank Lloyd Wright Foundation, this test provides that conceptual separability should evolve to accord protection not only to the artistic sculpture or separable ornamentation of a structure, but also to the overall shape of the structure.[203] More specifically, the test suggests that design features will vary according to the structure and that some structures will include design features, such as separable ornamentation or artistic sculpture, although others will not.[204] The test further provides that buildings that do not contain separable ornamentation or artistic sculpture may have an overall shape that itself could be considered a protected design feature.[205] In short, the test concludes that the scope of protectible design features should include not only separable ornamentation and artistic sculpture, but also the overall shape of a building. For instance, "it could be reasoned that the Guggenheim is a building; that as a building it has an overall shape; that the artistic features of the Guggenheim are its overall shape"[206] and that, therefore, the overall shape should be protected.

Like the dual function test suggested by the Frank Lloyd Wright Foundation, this test applies existing copyright law to protect architectural works. It recognizes that a building's design or overall shape can be set apart from its utilitarian function and recognized as protectible subject matter. The weakness, however, that sets this test apart from the dual function test is that it would deny protection to the overall shape of an architectural work when the overall shape facilitates the utilitarian aspects of the building.

D. *Has Conceptual Separability Evolved to the Extent That It Provides Adequate Protection to Works of Architecture?*

The conceptual separability test currently in use by the Copyright Office should be abandoned to the extent that it does not recognize or protect the overall shape of a structure. Furthermore, although conceptual separability arguably has evolved to accord protection to the overall shape of a building as discussed in the aforementioned tests, this form of protection is insufficient in the face of article 2(1) of the Berne Convention which expressly provides that works of architecture are protected.[207]

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203. Copyright Office Report, *supra* note 1.

204. *Id.*

205. *Id.*

206. *Id.* A more definitive analysis is as follows: Can the ordinary observer recognize the presence of artistic features in the overall shape of the building? If so, are those features dictated by the utilitarian aspects of the structure (*i.e.*, is the overall shape of the building designed to facilitate the utilitarian aspects of the building)? If not, then the artistic features are conceptually separable (protectible). *Id.*

207. Berne Convention (Paris text), *supra* note 52, art. 2(1), at 27-1 to -2.

Other members of the Berne Union recognize that works of architecture are works of authorship and have drafted legislation granting works of architecture protection equal to that of other art forms.[208] It behooves Congress to grant protection to works of architecture equal to that afforded in other countries.

III. The Berne Convention Protects Works of Architecture

Article 2(1) of the Berne Convention provides that the expression "literary and artistic works" shall include "every production in the literary, scientific and artistic domain, whatever may be the mode or form of its expression."[209] Among the works protected by article 2(1) are works of architecture, illustrations and plans relative to architecture, and three-dimensional works relative to architecture.[210] The copyright law adequately protects illustrations and plans relative to architecture[211] and three-dimensional works relative to architecture.

However, the issue remains whether the current composite of United States Copyright Law protecting works of architecture is sufficient to adhere to the Berne Convention, especially when considering the protection other member nations afford works of architecture. The scope of this Note precludes in-depth discussion of the protection other member nations grant to works of architecture. Nonetheless, broad generalizations may be considered. First, other nations either include works of architecture as a subclass of "artistic works" or they create a separate category for architectural works as protected subject matter.[212] All nations regard architectural works, if original, as artistic creations.[213] The concept of originality, however, can mean different things depending on the country.[214] Originality can require that the author of the work claim that he created the work without copying a substantially similar building, or it can require that the work of architecture "convey a personal intellectual, artistic, or other creative character."[215] Most often, however, works of architecture are protected even though they have no artistic merit.[216]

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208. Copyright Office Report, *supra* note 1, at 223. "The copyright law of virtually every Berne member country makes express reference to protection for buildings and structures." *Id.*

209. Berne Convention (Paris text), *supra* note 52, art. 2(1), at 27-1 to -2.

210. *Id.*

211. Recall that the architect is not adequately protected when his plans, although not copied, are used to build a substantially similar structure. *See supra* text accompanying notes 110-19 (where it is argued that the architect should be protected in this situation).

212. Copyright Office Report, *supra* note 1, at 162.

213. *Id.* at 162-63.

214. *Id.*

215. *Id.*

216. *Id.* at 223.

Additionally, all nations protect works of architecture without regard to whether the work has a utilitarian function by providing that the utilitarian aspects of a work are not protectible subject matter.[217] The remedies afforded architectural works are often the same as those for other works, except that when the structure is substantially completed, destruction is not available.[218]

When deciding what changes were necessary in the area of protection for works of architecture, Congress was confused and uncertain. Although it initially heard testimony that the current composite of the law protecting such works was inadequate,[219] Congress later chose not to make any changes to the 1976 Act once it heard testimony that current United States law satisfies article 2(1)'s requirements for architectural protection.[220] To alleviate much of the confusion, Congress asked the Copyright Office to conduct a study. Specifically, Congress asked the Copyright Office to address the issue of architectural protection — deciding what structures should be protected and how this should be done.[221]

The Copyright Office released its report on June 19, 1989, and asked Congress to consider amending the law concerning works of architecture.[222] Additionally, the report offered four possible ways in which United States law could be brought into conformity with the requirements of the Berne Convention.[223] Ironically, however, the report

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217. *Id.* at 163.

218. *Id.*

219. *U.S. Adherence to the Berne Convention: Hearings Before the Subcomm. on Patents, Copyrights and Trademarks of the Senate Judiciary Comm.*, 99th Cong., 1st & 2d Sess. (1985) (statement of Irwin Karp, Chairman of the Ad Hoc Working Group on U.S. Adherence to the Berne Convention). See Copyright Office Report, *supra* note 1, at 103-06.

220. *The Berne Convention: Hearings on S.1301 and S.1971 Before the Subcomm. on Patents, Copyrights, & Trademarks, Senate Judiciary Comm.*, 100th Cong., 2d Sess. 182 (1988) (statements of Professor Paul Goldstein and former Register of Copyrights Barbara Ringer).

> The essence of this testimony is that present law, including the requirement of conceptual separability, is sufficient to provide protection for architectural works (and features of such works) based upon their demonstrable artistic character. The belief that [U.S. law] was compatible with the Berne Convention rested upon the fact that many Berne Union countries did not generally protect buildings *per se*, but only those containing clear artistic features or character. In short, that absent a more detailed examination, the requirements of artistic content (but not quality) present in Berne legislation might tend to produce similar results when variant U.S. tests of copyrightability were applied to the same subject matter.

Copyright Office Report, *supra* note 1, at 216.

221. Copyright Office Report, *supra* note 1.

222. Copyright Office Report, *supra* note 1, preface, at vi.

223. Copyright Office Report, *supra* note 1, at 223-26.

did not issue an opinion as to which solution was the best or what types of structures should be protected.[224]

The four possibilities mentioned in the report are: (1) do nothing and allow the courts to develop new legal theories of protection under existing statutory and case law, as they attempt to come to grips with the United States's adherence to the Berne Convention;[225] (2) amend the 1976 Act to give the copyright owner of architectural plans the right to prohibit unauthorized construction of substantially similar buildings based on those plans;[226] (3) amend the definition of "useful article" in the 1976 Act to exclude unique architectural structures;[227] and (4) create a new subject matter category for works of architecture in the 1976 Act and legislate appropriate limitations.[228]

IV. Analysis of the Alternatives Mentioned by the Copyright Office for Protection of Works of Architecture

A. Do Nothing and Allow the Courts to Develop New Legal Theories of Protection Under Existing Statutory and Case Law

The first option, that Congress do nothing and allow the courts to develop new legal theories of protection under existing statutory[229] and case law,[230] appears attractive because further legislation is not needed to protect works of architecture. Furthermore, this alternative appears equitable because the courts would be deciding, on an ad hoc basis, which works of architecture to protect. Arguably, only the most deserving architectural works would receive protection.

However, legislative abdication is not the best alternative because it leaves the courts with the insurmountable task of developing new legal theories from inadequate statutory law and case law that purports to protect works of architecture. Other member nations have passed legislation that provides for protection of works of architecture, and these nations have done so in an equitable manner by providing that works must be original in order to receive copyright protection.[231] In short, because case law, statutory law, and the conceptual separability test currently used by the Copyright Office protect only the separable or-

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224. *Id.* at 226.
225. *Id.* at 225-26.
226. *Id.* at 224.
227. *Id.* at 225.
228. *Id.* at 223-24.
229. *See supra* text accompanying notes 130-34.
230. *See supra* text accompanying notes 135-45.
231. *See supra* text accompanying notes 211-15.

namentation of a building, it is evident that Congress must legislate to protect works of architecture to put the United States on par with other member nations.

B. Amend the 1976 Act to Give the Copyright Owner of Architectural Plans the Right to Prohibit Unauthorized Construction of Substantially Similar Buildings Based on Those Plans

This alternative was proposed by the American Institute of Architects [AIA]. It prohibits the situation in which an architectural work is copied by the unauthorized use of the copyrighted plans to construct an identical, second structure.[232] However, this alternative is inadequate. Absent the use of copyrighted plans to build a substantially similar structure, copyright infringement would not exist. If a substantially similar building was built from either measured drawings or a photograph of the original structure, and not from the structure's copyrighted plans, there would be no infringement.[233] The AIA rationalizes that because the plans are copyrightable material, they are infringed upon when someone uses them without authorization to build a substantially similar structure.[234] The AIA further argues, however, that because a structure is not copyrightable subject matter, it cannot be infringed upon when a person's own measured drawings of the structure are used to build a substantially similar structure.[235] According to this rationale, protection is only afforded to the plans of a structure, but not the structure itself because the offending act is not the construction of a substantially similar building, but the use of copyrighted plans to build that building.[236] This argument is unreasonable because it merely amounts to saying that "[i]t's okay to copy the appearance of that house identically but don't you dare use the underlying plans to achieve the same result."[237]

This alternative is inadequate because it only protects the architect in the limited situation in which a person "obtain[s] a set of blueprints and, while not engaging in any unauthorized copying, . . . use[s] the blueprints to construct a duplicate structure without authorization."[238] It does not sufficiently protect the architect in the situation in which

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232. Proskauer, *supra* note 121, at 4. *See supra* text accompanying notes 110-19.

233. *Id.* "Time-honored practices of making 'measured drawings' from others' buildings and borrowing design elements (except conceptually severable copyrighted works) would be unaffected; competitors would only be barred from constructing a new building from others' copyrighted plans." *Id.*

234. *Id.*

235. *Id.*

236. *Id.*

237. Frank Lloyd Wright Found., *supra* note 123.

238. G. Quatman & M. Brown, *supra* note 121.

sketches are made of a structure's exterior or interior through careful observation and then are used as measured drawings to build a substantially similar building.[239] However, both situations equally divest the architect's interest in protecting his work.[240] An architect should be protected from the imitator who uses measured drawings to construct a substantially similar building because the imitator is doing nothing more than using another person's original expression of an idea for his own benefit.

This is not to say that an imitator cannot use ideas as they appear individually in a work of architecture. Such a proposition would be violative of the principle found in *Baker v. Selden* and section 102(b) that an architect does not have exclusive rights to the design ideas, concepts, and methods of construction disclosed in his copyrighted plans.[241] This proposition merely suggests that an imitator should not be able to take from a building the architect's original expression or compilation of ideas, and use them to build a substantially similar building.

The concern that prohibiting the use of measured drawings and thereby protecting works of architecture would constitute protecting the utilitarian aspects of the architectural work is misleading. Granting protection to the compilation of design ideas that comprise the architectural work would not constitute protection of the utilitarian aspects of the architectural work because most, if not all, design ideas bear no connection to the functional needs of a structure.[242] In fact, the absence of most design ideas from a structure or building would have no effect on the function of these structures or buildings.[243] Additionally, recall that experts in copyright law agree that neither *Baker v. Selden* nor section 102(b), which prohibits copyright protection of ideas, procedures, processes, systems, and methods of operations, precludes the design of a structure from being protected.[244] In effect, these experts conclude that the design of a building or structure is not section 102(b) subject matter and is, therefore, protected by copyright law.[245] Thus, the compilation of design ideas that comprise a work of architecture should be subject to copyright protection apart from those utilitarian aspects of the struc-

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239. *See supra* text accompanying notes 120-23.

240. *Id.*

241. *See supra* text accompanying notes 117-18.

242. COPYRIGHT OFFICE REPORT, *supra* note 1, at 211. "The relative importance of function in architecture is vastly overemphasized, (footnote omitted) perhaps as a result of unfamiliarity with the discipline. (footnote omitted) Very few architectural design elements are actually required by functional needs. There are hundreds, if not thousands, of non-functional design options in many architectural structures." *Id.*

243. *Id.*

244. *See supra* text accompanying notes 149-52.

245. *Id.*

ture, such as methods of construction, that are denied such protection.[246]

Allowing the architect to recover when measured drawings are used to build a substantially similar building would not open the floodgates of litigation because it would be harder to prove infringement. Copyright infringement will be more difficult to prove in this situation because the plaintiff will not be able to show copying or use of his plans.[247] Thus, the architect must prove that the imitator had access to or viewed the structure, and that the second structure's exterior and interior are substantially similar to the original structure.[248] In summary, protecting the architect when his plans are used to build a substantially similar building is inadequate because it only extends copyright protection to the architect's plans and not to the work of architecture itself.

C. Amend the Definition of "Useful Article" in the 1976 Act to Exclude Unique Architectural Works

Congress could amend the definition of "useful article" in section 101 of the 1976 Act to exclude unique architectural structures.[249] Consequently, the conceptual separability test found in the definition of pictorial, graphic, and sculptural works would no longer apply to unique architectural structures.[250] Recall that the design of a useful article will be considered a pictorial, graphic, or sculptural work when the design incorporates features that can be identified separately from, and are capable of existing independently of, the utilitarian aspects of the article.[251] Thus, by excluding "unique architectural structures" from the definition of "useful articles," such structures would be considered "pictorial, graphic, or sculptural works," not useful articles subject to the conceptual separability test. Therefore, protection would not be limited to the separable ornamentation of the architectural work. It would extend to the work itself.

This alternative is narrow in scope protecting only unique works of architecture rather than a broad class of architecture, such as single-

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246. *Id.*

247. D. Shipley, Response to the Copyright Office Notice of Inquiry on Architectural Work Protections (Sept. 10, 1988), *reprinted in* COPYRIGHT OFFICE REPORT, *supra* note 1, app. C, comment 3, at 3.

248. Shipley, *supra* note 91, at 446-47.

249. COPYRIGHT OFFICE REPORT, *supra* note 1, at 225. Therefore the new definition would be [*insertion*]: "A 'useful article' is an article having an intrinsic utilitarian function that is not merely to portray the appearance of the article or to convey information. An article that is normally a part of a useful article is considered a 'useful article'. *A 'unique architectural structure' does not constitute a 'useful article'.*" 17 U.S.C. § 101 (1976).

250. *Id.*

251. *Id. See supra* text accompanying note 134.

family housing. The Copyright Office Report states, however, that despite its narrow scope, this alternative should be considered because the impact of the change in the law affecting works of architecture would be minimized, the most deserving architectural structures would be protected, and the conceptual separability analysis would no longer apply.[252]

As the Copyright Office suggested, this alternative is worthy of consideration, especially because, unlike any of the other legislative solutions previously discussed, it extends copyright protection to architectural works. However, although this alternative seems to be ideal, the Copyright Office has neglected to define the term "unique architectural work." By not providing a definition of this term, Congress left for the courts the almost insurmountable task of deciding which architectural works are unique and worthy of protection. That is, because the term "unique architectural work . . . eludes precise definition"[253] there will be great uncertainty among the courts when determining which structures to protect.

In addition, the uniqueness requirement treats architectural works differently than other protectible subject matter, such as music or literature. For instance, the 1976 Act does not require that only unique musical works be protected; rather section 102(a) of the 1976 Act provides that "[c]opyright protection subsists . . . in original works of authorship." Because architecture is a form of art equivalent to music and literature, it should not be held to a higher standard, such as uniqueness, to receive copyright protection. In short, an architectural structure should be protected when it is original.

Limiting protection only to unique architectural structures is conservative when compared to the majority of the countries belonging to Berne, which protect works of architecture without expressly imposing a higher level of originality, such as artistic merit.[254] Melville Nimmer argued that the controlling principle for copyright protection for works of architecture should be the same as it is for all works of authorship:[255] the work must be of an original nature to be protected.[256] "[A]rchitectural structures in themselves should . . . be the subject of copyright protection, and [it] is undesirable to make any arbitrary distinction as to 'artistic'

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252. Copyright Office Report, *supra* note 1, at 225.

253. Copyright Office Study No. 27, in Strauss, *Copyright in Architectural Works* (1959), *reprinted in* Senate Committee Print, 86th Cong., 2d Sess., 1966 Copyright L. Revision Study 77.

254. Copyright Office Report, *supra* note 1, at 159.

255. M. Nimmer, *Comments and Views Submitted to the Copyright Office on Copyright in Architectural Works* (1959), *reprinted in* Senate Committee Print, *supra* note 253, at 86.

256. *Id.*

structures. If the form of the structure may be said to be original, this should be sufficient."[257]

D. Create a New Subject Matter Category Under Section 102(a) of the Copyright Act of 1976 for Works of Architecture

Congress could protect works of architecture by creating a new subject matter category.[258] Recall that section 102(a) of the 1976 Act provides an illustrative list of copyrightable works.[259] Those areas currently protected are literature; music; pantomime and choreography; pictorial, graphic, and sculptural works; motion pictures and audiovisual works; and sound recordings.[260] This list, however, is illustrative, not limiting.[261] Although Congress did not intend every writing to be copyrightable, it still left section 102(a) undefined because it did not want to "freeze the scope of copyrightable subject matter at the present stage of communications technology or . . . allow unlimited expansion into areas completely outside the present Congressional intent."[262]

Congress could expand copyright protection beyond that accorded in section 102(a) in two instances: first, when a new form of creative expression is made possible by a scientific discovery or technological development; and, second, when an existing form of expression is recognized as creative and worthy of protection.[263]

Architecture is not a new form of creative expression, but it is an existing form that arguably should be recognized as creative and worthy of protection. Music, drama, and works of art were not accorded protection under the first Copyright Statute of 1790, but they were later recognized as worthy of protection and included within section 102(a).[264] Thus, because music, drama, and works of art are no more creative than architecture, it necessarily follows that architecture should be worthy of the same protection by creating a new subject matter category for works of architecture under section 102(a) of the 1976 Act. Opponents to this alternative characterize the granting of protection to works of architecture as opening a "can of worms."[265] They argue that although

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257. *Id.*

258. Copyright Office Report, *supra* note 1, at 223-24.

259. 17 U.S.C. § 102(a) (1976).

260. *Id.*

261. H.R. Rep. No. 1476, 94th Cong., 2d Sess. 53 (1976).

262. *Id.* at 51.

263. *Id.*

264. *Id.* at 51-52.

265. *Berne Convention Implementation Act of 1987, Hearings Before the Subcommittee on Courts, Civil Liberties, and the Administration of Justice of the Committee on the Judiciary, House of Representatives*, H.R. 1623, 100th Cong., 1st & 2d Sess. 679-80 (June 17 & 23, Sept. 16 & 30, 1987, Feb. 9 & 10, 1988). *See* Copyright Office Report, *supra* note 1, at 132.

other countries protect works of architecture, and article 2(1) of the Berne Treaty specifically provides protection for architectural works, such protection nonetheless will cause great uncertainty and confusion in the law.[266] For example, because the Berne Convention vests in the architect the right to control subsequent construction of his work, opponents assert that questions surrounding zoning laws or the tearing down of homes for eminent domain purposes would be confused.[267] However, such confusion would be alleviated by thoughtful congressional consideration of these uncertainties and by carefully drafted legislation. A few uncertainties should not preclude the United States from protecting works of architecture, especially when other countries adhering to Berne have overcome these uncertainties or found them to be minimal, and instead have chosen to recognize architecture as a protected art form.

Additionally, opponents argue that protecting works of architecture would not be in the architect's best interests because it would "stifle the creativity of architects,"[268] and add the undue burden of originality verification.[269] Protecting works of architecture would not stifle the creativity of architects because the only protectible aspect of a structure would be the compilation of design ideas which form the architect's own original expression.[270] Copyright protection would not protect individual design ideas that are "staple, commonplace, or familiar in the industry."[271] Such protection would create monopolization of ideas in violation of the principles enunciated in *Baker v. Selden* and codified in section 102(b). Therefore, because design elements that have been

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266. *Berne Convention Implementation Act of 1987, Hearings Before the Subcommittee on Courts, Civil Liberties, and the Administration of Justice of the Committee on the Judiciary, House of Representatives*, H.R. 1623, 100th Cong., 1st & 2d Sess. 679-80 (June 17 & 23, Sept. 16 & 30, 1987, Feb. 9 & 10, 1988). *See* COPYRIGHT OFFICE REPORT, *supra* note 1, at 132.

267. *Id.*

268. F. Arvan, Response to Copyright Office Notice of Inquiry on Architectural Work Protections (Aug. 16, 1988), *reprinted in* COPYRIGHT OFFICE REPORT, *supra* note 1, app. C, comment 1. *See* G. Quatman & M. Brown, *supra* note 121, at 4.

269. F. Arvan, Response to Copyright Office Notice of Inquiry on Architectural Work Protections (Aug. 16, 1988), *reprinted in* COPYRIGHT OFFICE REPORT, *supra* note 1, app. C, comment 1. *See* G. Quatman & M. Brown, *supra* note 121, at 4.

270. Shipley, *supra* note 91, at 445.

271. Frank Lloyd Wright Found., *supra* note 123, at 4. "There can be originality, and protectibility, for . . . [architectural] works, regardless of whether they include elements of the staple, the commonplace or the familiar." *Id. See also* J.W. Henderson on behalf of IBM, Response to Copyright Office Notice of Inquiry on Architectural Work Protections (Sept. 16, 1988), *reprinted in* COPYRIGHT OFFICE REPORT, *supra* note 1, app. C, comment 7, at 2-3. "Architectural works or any other category [should not] be discriminated against merely because they might include elements which are 'staple, commonplace, or familiar in the industry.'" *Id.*

duplicated throughout history would not be protected under copyright law, architects could continue to "borro[w] ideas and concepts, or imitat[e] the general styles of their contemporaries and predecessors"[272] without the fear that they would be infringing the rights of others and be, therefore, subject to liability.

Architects would not be burdened with the worry of originality verification — that their structure would violate another copyrighted structure — because they would only be subject to liability when there has been an affirmative act to duplicate an already existing copyrighted structure. Architects will only be subject to liability when they use or copy copyrighted plans to build a substantially similar building.[273]

Furthermore, a strong presumption of copyright infringement will attach when the architect's building is substantially similar to the copyright owner's building, and the copyright owner proves that the architect had access to the copyrighted building.[274] It must be noted, however, that this is a heavy burden for the copyright owner. "Access" does not mean that simply because the building is in the public domain, the architect had access to it. Rather, access connotes the affirmative act of walking through the building, taking pictures of the building, or making measured drawings from observations of the building.[275] Therefore, an architect would not be subject to liability when the architect does not affirmatively attempt to duplicate the original structure, but does so anyway by mere coincidence.

Opponents also argue that architecture is not worthy of copyright protection commensurate to that of other works of authorship, such as literary works or musical works, because "an architectural structure is usually composed of standard elements capable of being synthesized by craftsmen and therefore the individualized artistic flair is often less apparent than in the work of the writer, painter, or sculptor."[276] This view that architecture is less deserving of copyright protection than are other works of authorship is disheartening. Perhaps a reason for this view is that we are often too familiar with works of architecture to

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272. Shipley, *supra* note 91, at 445.

273. *Id.* at 446. *See* D. Shipley, *supra* note 247, at 2-3. "With some simple structures the substantial similarity of protected expression test would not be satisfied unless the copying amounted to almost verbatim reproduction of the entire structure. . . . [C]ourts should not hesitate to find infringement when copying is established and the plaintiff shows that the internal plans of the two structures are substantially similar." *Id.*

274. *Id.*

275. D. Shipley, *supra* note 247.

276. J. Cahn, *Comments and Views Submitted to the Copyright Office on Copyright in Architectural Works* (1959), *reprinted in* Senate Committee Print, 86th Cong., 2d Sess., 1966 Copyright L. Revision Study 86.

consider them an art form.[277] We know so many of the particulars about a work of architecture, such as its location, its insurance rates, its mortgage payments, and its occupants that our perception of it as an art form is often obscured.[278]

Additionally, works of architecture are often emphasized for their utilitarian aspects or function.[279] However, as mentioned earlier, most, if not all, design ideas bear no connection to the functional needs of a structure.[280] In fact, the absence of most design ideas from a structure or building would have no effect on the function of these structures or buildings.[281] It is for this reason that the compilation of design ideas that comprise a work of architecture should be regarded for their artistic aspects rather than their utilitarian aspects.

Indeed, the compilation of design elements chosen by an architect when designing a building is no different than the "sequence and arrangement of notes"[282] chosen by a musician when composing a song or the "choice and arrangement of colors [and] lines"[283] selected by an artist when painting a portrait. "Like composers, painters, and poets, an architect's choices reflect subjective, aesthetic judgment that constitutes the essence of creativity, the encouragement of which forms the foundation of copyright."[284]

If Congress should take this route and include works of architecture within the subject matter of section 102(a), other issues must be considered.[285] These issues are the exact nature of the buildings covered by the new subject matter, the nature of the limitations on the exclusive rights, and the nature of the remedies. [286] These issues were originally discussed in House Resolution 1623.[287]

House Resolution 1623 was introduced in early 1987 when the United States was deliberating Berne adherence.[288] It would have provided protection for architectural works by including in section 101 of the 1976 Act a definition of architectural works,[289] and amending the definition

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277. Copyright Office Report, *supra* note 1, at 211 n.36.
278. S. Ambercrombie, Architecture As Art 7 (1983).
279. Copyright Office Report, *supra* note 1, at 211.
280. *Id. See supra* text accompanying notes 241-42.
281. Copyright Office Report, *supra* note 1, at 211.
282. *Id.*
283. *Id.*
284. *Id.*
285. *Id.* at 223-24.
286. *Id.*
287. H.R. 1623, 100th Cong., 1st Sess. 1 (1987).
288. *Id. See* Copyright Office Report, *supra* note 1, at 123.
289. H.R. 1623, 100th Cong., 1st Sess. 3, § 4(a) (1987). "Section 101 is amended by inserting after the definition of 'anonymous work' the following: 'Architectural works'

of pictorial, graphic, and sculptural works to exclude architectural works.[290] The legislation also amended section 102(a) by including architectural works as protectible subject matter.[291] The scope of protection afforded architectural works was limited to the work's artistic character and artistic design.[292] It did not include protection for the methods of construction or processes of the work.[293] The legislation also provided that a copyright owner would not be entitled to injunctive relief when the structure was substantially begun.[294] In particular, equitable remedies such as stopping construction, seizure, or demolition would not be available because such remedies would result in economic waste.[295] Finally, the owner of the work of architecture was granted the permission to modify the structure without fear of infringing the architect's rights in the structure provided that the modifications were minor or necessary for the use of the structure.[296]

In July of 1987, however, House Resolution 1623 was amended and introduced as House Resolution 2962.[297] The two bills were very similar except that House Resolution 2962 did not include within the definition of an architectural work that the work must be of an "original artistic

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are buildings and other three-dimensional structures of an original artistic character, and works relative to architecture, such as building plans, blueprints, designs, and models." *Id.*

290. *Id.* "Section 101 is amended in the definition of 'Pictorial, graphic, and sculptural works' by inserting before the period at the end of the first sentence ', other than architectural works'." *Id.*

291. *Id.* at 5, § 5. "Section 102(a) is amended — (1) by redesignating paragraphs (6) and (7) as paragraphs (7) and (8), respectively; and (2) by inserting after paragraph (5) the following: '(6) architectural works;'." *Id.*

292. *Id.* at 10, § 9(a). "Processes or Methods of Construction Not Protected. The exclusive rights of a copyright owner in an architectural work shall apply only to the work's artistic character and artistic design and shall not extend to processes or methods of construction." *Id.*

293. *Id.*

294. *Id.* at 12, § 9(c).

> Limitations Regarding Construction. The owner of the copyright in an architectural work (1) shall not be entitled to obtain an injunction under section 502 of this title restraining the construction or use of an infringing building, if construction has substantially begun; and (2) may not, under any circumstances, obtain a court order under chapter 5 of this title requiring that an infringing building be demolished or seized.

Id.

295. *Id.*

296. *Id.* at 12, § 9(d). "Alterations to Buildings. The owners of a building embodying an architectural work may, without the consent of the author or copyright owner, make or authorize the making of minor alterations to such building, or other alterations to such building in order to enhance the utility of the building." *Id.*

297. H.R. 2962, 100th Cong., 1st Sess. (1987). *See* COPYRIGHT OFFICE REPORT, *supra* note 1, at 126.

character."[298] Instead, House Resolution 2962 defined an architectural work as "a work such as a building or other three-dimensional structure and related works such as plans, blueprints, sketches, drawings, diagrams, and models relating to such building or structure."[299] Further, House Resolution 2962 differed in that it prohibited copyright in the utilitarian features of an architectural work, and it gave the owner of the building additional control over the reconstruction of the building once it was completed.[300] Nonetheless, despite the minor differences between House Resolution 1623 and House Resolution 2962, the central precept of the two bills, creating a new subject matter category for works of architecture, is the most appropriate alternative because it recognizes architecture for what it is — a work of authorship worthy of copyright protection equal to that enjoyed by other art forms.

Congress should create a new subject matter category for works of architecture under section 102(a).[301] However, this protection should not be unlimited. First, to protect only the most deserving architectural structures, section 101 should include within the definition of architectural works a requirement that the architectural work must be of an original character to be worthy of protection.[302] Including within the definition

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298. Copyright Office Report, *supra* note 1, at 126.

299. *Id.*

300. *Id.*

301. G. Quatman & M. Brown, *supra* note 121, at 17. The proposed amendment is as follows:

17 U.S.C. § 102 (1976). Subject matter of copyright:

In general

> (a) Copyright protection subsists, in accordance with this title, in original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. Works of authorship include the following categories:
> (1) literary works;
> (2) musical works, including any accompanying words;
> (3) dramatic works, including any accompanying music;
> (4) pantomimes and choreographic works;
> (5) pictorial, graphic, and sculptural works;
> (6) motion pictures and other audiovisual works;
> (7) sound recordings[]; *and*
> *(8) architectural works.*

Id. (emphasis added).

302. *Id.* Section 101 would be amended to include the following definition of "architectural works" (*insertion*):

> § 101. Definitions. *"Architectural works" include buildings and other three-dimensional structures of an original character, and works relative to architecture, such as building plans, elevations, designs, sketches, drawings, blueprints and models.*

Id. (emphasis added).

of architectural works the additional requirement that an architectural work must be of an "original artistic character" in order to enjoy copyright protection would present the courts with the almost impossible task of determining what structures are artistic in nature. Although some countries adhering to the Berne Convention require that works of architecture possess an artistic character or design, commentators argue that "this reference is, in practice, only the general standard of originality."[303] Because works of architecture are art forms equivalent to other works of authorship currently protected by section 102(a), they should be held to the same standard: "originality without more."[304]

Further, to prevent the monopolization of ideas, the new legislation also should clearly provide that the scope of exclusive rights in architectural works does not include processes or methods of construction or purely utilitarian features of such works.[305] Moreover, to prevent economic waste, the legislation should state that remedies do not include injunctions to restrain the construction or use of an infringing building once construction has substantially begun, and that remedies do not include demolition or seizure of the infringing building.[306] Rather, the legislation should provide that remedies are limited to monetary awards based on the plaintiff's damages or based on the defendant's profits.

Finally, to protect the use of a structure, the legislation should provide that the owner of the building may make alterations to it without infringing the copyright in the building if the alterations are necessary for the building's maximum utility.[307]

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303. *Id.* at 159 n.5. *See* W. Copinger and S. James, On Copyright 718, at 299 (11th ed. 1971).

304. Proskauer, *supra* note 121, at 5.

305. G. Quatman & M. Brown, *supra* note 121, at 17. Section 119 would be amended to define the scope of exclusive rights in architectural works as follows (*insertion*):

§ *119. Scope of exclusive rights in architectural works.*

(a) The exclusive rights of a copyright owner in an architectural work are limited to those rights specified in clauses (1), (2), (3), (5), and (6) of Section 106, and shall not extend to processes or methods of construction or purely utilitarian features of such works.

Id.

306. *Id.* Section 119 should further include the following (*insertion*):

(c) The owner of a copyright in an architectural work —

(1) shall not be entitled to obtain an injunction under section 502 of this title to restrain the construction or use of an infringing building, if construction has substantially begun; and

(2) may not obtain a court order, under chapter 5 of this title, requiring that an infringing building be demolished or seized.

Id.

307. *Id.* at 18. Section 119 should finally include the following (*insertion*):

(d) It is not an infringement of copyright in an architectural work for the

V. Conclusion

Most countries grant copyright protection to architectural works and architectural plans. The United States, however, grants architectural works and architectural plans second class protection. The Copyright Act of 1976 affords copyright protection only to monumental structures and the separable ornamentation of functional structures. Although copyright law protects architects from those who duplicate their plans into another set of plans, it does not prohibit imitators from the unauthorized use of those plans in building the structure the plans depict. Furthermore, copyright law does not protect against those who attempt to build a substantially similar structure from photographs or measured drawings of the original building.

If the United States hopes to become a country on par with other countries in the copyright community, it must provide copyright protection to works of architecture, which other countries adhering to the Berne Convention recognize and which the Berne Treaty itself dictates. The United States must also grant architects copyright protection against the unauthorized use of their plans and the use of measured drawings to build a substantially similar building. Creating a new subject matter category for works of architecture under section 102(a) of the Copyright Act of 1976 would afford architectural works and plans the protection they deserve, and prove to the world that the United States is a full-fledged member of the Berne Convention.

Laura E. Steinfeld*

> *owner of a building embodying such architectural work, without the consent of the author or copyright owner, to make or authorize the making of alterations to such building, in order to enhance the utility of the building.*

Id.

* B.S., Indiana University, 1987; J.D. candidate, Indiana University School of Law-Indianapolis, 1991. Special thanks to my father for his assistance in editing this Note.